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RATEPAYER PROTECTION ACT OF 1985

HEARING

BEFORE THE

SUBCOMMITTEE ON WATER AND POWER

OF THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 1149

A BILL TO AMEND THE FEDERAL POWER ACT TO ALLOW STATE COMMISSIONS TO DETERMINE WHETHER TO EXCLUDE ALL OR PART OF A RATE SET BY THE FEDERAL ENERGY REGULATORY COMMISSION BASED ON CONSTRUCTION COSTS

JULY 23, 1986

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RATEPAYER PROTECTION ACT OF 1985

WEDNESDAY, JULY 23, 1986

U.S. Senate,
Subcommittee on Water and Power,
Committee on Energy and Natural Resources,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:30 p.m., in room SD-366, Dirksen Senate Office Building, Hon. Frank H. Murkowski presiding.

Present: Senators Murkowski, Warner, Bumpers, Ford, Bradley, Rockefeller, and Pryor.

Also present: Russell R. Brown, professional staff member; and Elizabeth Moler, counsel for the minority.

Senator **Murkowski**. We will call the hearing to order, the Subcommittee on Water and Power of the Committee on Energy and Natural Resources.

In order to accommodate my colleagues and those of you who have been waiting since 2 p.m. when the hearing was to begin, you should be aware that we had a vote on the Senate floor, the Manion nomination tie break was by the Vice President, and as a consequence Manion was confirmed by the Senate. With that bit of recent activity, I would defer to my colleague and good friend, Senator Warner, and then I will go into the formal opening statement which I have.

Senator Warner.

STATEMENT OF HON. JOHN W. WARNER, A U.S. SENATOR FROM THE STATE OF VIRGINIA

Senator **Warner**. Thank you, Mr. Chairman. I must chair a committee meeting of the Armed Services Committee beginning now. I will not be able to remain for the hearing, but I wanted to exercise the privilege and courtesy accorded me of introducing the attorney general of the Commonwealth of Virginia, Mary Sue Terry, who will be making her first appearance before the U.S. Senate today on panel 2.

The attorney general served five terms in the Virginia House of Delegates and was a member of the Corporations Insurance and Banking Committee. This particular committee of our State legislature is charged with the oversight responsibility for State utility issues. Given this experience and background of our distinguished attorney general, I am certain that her views on this legislation will be of great import to the committee.

Speaking of backgrounds, the attorney general and I both attended the University of Virginia. I hasten to add I was a generation and a half ahead of her, so in her defense I make that observation.

Also, I would like to recognize Dr. Roger Sherman, professor of economics at the University of Virginia, who will be joining the attorney general to testify on this legislation.

I welcome both of my constituents and thank the Chair for the courtesy.

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM THE STATE OF ALASKA

Senator Murkowski. Thank you very much, Senator Warner.

Let me begin by wishing you a good afternoon. The purpose of the hearing today before the Subcommittee on Water and Power is to receive testimony on two interrelated items.

I notice there is a good deal of interest in the hearing, and I want to make it very clear, as I have to my colleague and good friend, Senator Bumpers, who will be joining us, that it is very infrequent that we schedule anything other than business meetings before this subcommittee. This is no case in point to depart from that.

While it is a little unusual that we may have opponents appearing either as witnesses or incumbents appearing in their stead as members of the Energy Committee, it is strictly by coincidence and on accommodation on the part of the staff in the interest of obtaining full information on the subject at hand and by no means should be construed to have any political connotation.

As a consequence, Senator Bumpers, I was just explaining in very general terms the fact that any relationship to this business hearing and any political activity is strictly by accident, perhaps with the concurrence of some of our friends on the staff who attempt to accommodate all points of view and all interests in the true democratic principle, one of whom, Russ Brown, is on my right.

In any event, we look forward to conducting this as we do all other business meetings, based on the information which you, the witnesses, have in relationship to the subject matter at hand.

I intended to conduct this hearing for a brief portion and then turn the hearing over to my colleague, Senator Bumpers. Before I do, I want to conclude my opening statement. I note we have Senator Pryor who has joined us, and we will have other witnesses as well.

The first item is the general relationship between the Federal Energy Regulatory Commission and related State public utility commissions.

The second item is S. 1149, which was introduced by my colleague on my left, Senator Bumpers, and cosponsored by Senator Pryor, who will be a witness very shortly. This would amend the Federal Power Act to allow State commissions to determine whether to exclude all or part of a rate set by the Federal Energy Regulatory Commission based on construction costs.

I would note for the record that this is an afternoon hearing, that we have many out-of-town witnesses. In deference to the right of all witnesses to be heard, I would encourage each of you to summarize your remarks, and I assure you that those remarks will be entered into the record in full.

In view of the fact that we do have two pages of witnesses, I would ask that you constrain yourselves to 5 minutes, and if there is anything in excess of that, why we will remind you of it in the sense of asking you to wrap things up. We will appreciate your cooperation.

As you know, the hearing had been previously scheduled for June 24, 1986. Circumstances forced a postponement. We appreciate your willingness to accommodate the change of the committee schedule. I think it is an indication of how important the issues in legislation before the subcommittee are to each one of you. Of course, I, as chairman, will be interested in compiling as complete a record as possible. The hearing record will remain open for a period of 2 weeks from today. I would ask that a copy of S. 1149 appear in the record at this point.

[The text of S. 1149 follows:]

99TH CONGRESS
1ST SESSION

S. 1149

To amend the Federal Power Act to allow State commissions to determine whether to exclude all or part of a rate set by the Federal Energy Regulatory Commission based on construction costs.

IN THE SENATE OF THE UNITED STATES

MAY 16 (legislative day, APRIL 15), 1985

Mr. BUMPERS (for himself and Mr. PRYOR) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

---

A BILL

To amend the Federal Power Act to allow State commissions to determine whether to exclude all or part of a rate set by the Federal Energy Regulatory Commission based on construction costs.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Ratepayer Protection Act of 1985".

SEC. 2. Subsection (a) of section 206 of the Federal Power Act (16 U.S.C. 824e(a)) is amended by—

(1) inserting "(1)" after "(a)"; and

(2) inserting after paragraph (1) as so designated by this section the following:

"(2)(A) Notwithstanding any other provision of this Act, if—

"(i) a rate or charge fixed or permitted to take effect by the Commission is—

"(I) applicable to the transmission or sale of electric energy subject to the jurisdiction of the Commission by an associate company of a public utility holding company system to any other associate company of such system; and

"(II) based in whole or in part upon an allocation of electric energy or costs of production of electric energy from a generating unit; and

"(ii) the associate company receiving or purchasing the electric energy or being allocated such production costs is subject to the jurisdiction of a State commission which had not approved the construction of such generating unit,

then each such State commission which had not approved the construction shall have jurisdiction to make a determination not to take into account all or part of any such federally approved rate or charge in establishing a just and reasonable rate or charge for sales by the associate company.

"(B) The terms 'holding company system' and 'associate company' as used in this paragraph shall have the meanings provided by section 2 of the Public Utility Holding Company Act of 1935.".

SEC. 3. The amendments made by this Act shall apply to any rate or charge fixed or permitted to take effect pursuant to a final order issued by the Federal Energy Regulatory Commission on or after May 1, 1985.

○

Senator **Murkowski**. Senator Bumpers, would you care to make an opening statement?

Senator **Bumpers**. Mr. Chairman, I do have an opening statement which I will just deliver extemporaneously. Before doing that, I would like to ask that an organization called Ratepayers Fight Back have the opportunity to have their testimony placed in the record.

Senator **Murkowski**. Without objection.

[The prepared statement of Mr. Trotter, chairman, Ratepayers Fight Back, follows:]

Ratepayers Fight Back
P.O. Box 6030
Little Rock, Arkansas 72216
Phone (501) 376-6355

June 17, 1986

Honorable Frank Murkowski
Chairman
Water and Power Subcommittee
Committee on Energy and Natural Resources
U. S. Senate
Washington, D. C. 20510

Dear Senator Murkowski:

Please find attached my testimony on behalf of Ratepayers Fight Back on S. 1149, the Ratepayer Protection Act of 1985. Senator Bumpers invited testimony from our consumer coalition, and we urge you and the other subcommittee members to consider it at the hearings scheduled for June 24, 1986.

Our consumer coalition strongly believes that S. 1149 raises issues of national importance related to the proper role of state and federal regulators over the need for new electric generating facilities and the setting of retail electric rates. That proper role is threatened by practices of electric utility holding companies and recent decision-making of the Federal Energy Regulatory Commission.

We applaud the efforts by Senators Bumpers and Pryor, in proposing S. 1149, to clarify federal law so that state utility commissions may retain traditional jurisdiction to protect retail ratepayers from unapproved and unneeded power plant expansion.

Thank you for giving consideration to our testimony.

Sincerely,

Scott C. Trotter
Chairman

SCT/eaw

cc: Senator Dale Bumpers
Senator David Pryor

opeiu105aflcioclc

Invited Written Testimony

of

SCOTT C. TROTTER
Chairman

Ratepayers Fight Back
2101 Main Street
P. O. Box 6030
Little Rock, AR 72216
(501) 376-6355

on

The Ratepayer Protection Act of 1985
(S. 1149)

to the

U. S. Senate
Subcommittee on Water and Power
Committee on Energy and Natural Resources
Washington, D. C.

June 24, 1986

TESTIMONY OF SCOTT C. TROTTER
ON BEHALF OF
RATEPAYERS FIGHT BACK

Mr. Chairman and members of the Subcommittee, we appreciate the opportunity to file written testimony in the hearings scheduled for June 24, 1986 concerning the Ratepayer Protection Act of 1985, S. 1149.

Ratepayers Fight Back is a coalition of consumer organizations in Arkansas dedicated to preserving the traditional role of state utility commissions in the regulation of retail electric rates and the need for new power facilities. Such role, we believe, is threatened by recent decision-making of the Federal Energy Regulatory Commission regarding the allocation of generating and plant costs among members of electric utility holding companies. See Middle South Energy, 31 F.E.R.C. ¶ 61,305 (1985).

In its above-cited decision, the FERC ordered operating utilities of a multi-state holding company to pay for generating and production costs of a power plant built by a subsidiary of the company, even if the plant was not needed to serve the reasonable power requirements of one or more of the operating utilities and not approved or sited by state utility commissions having jurisdiction over such utilities. The FERC decision signals an attempt by the agency to assist electric utility holding companies in their ingenious schemes to circumvent the proper and traditional role of state utility commissions in this field.

S. 1149 represents a commendable effort to clarify federal law so that utility commissions in Arkansas and other states may be assured of authority to evaluate and approve or reject power purchases by electric utilities within their jurisdictions. The bill, if enacted, would go a long way towards eliminating the abuses that the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 et seq., recognized and sought to remedy.

The following discussion of S. 1149, while supportive in many respects, also will recommend modifications in order to fully empower state utility commissions to protect retail electric ratepayers while permitting the FERC to retain its legitimate role in setting wholesale power rates pursuant to the Federal Power Act, 16 U.S.C. § 824 et seq.

As drafted, S. 1149 allows the FERC to allocate generating and production costs of power plants to operating utilities of a multi-state holding company, but it also authorizes a state commission to disallow such costs in retail rates if the generating facility had not been approved by the commission. While supportive of the bill's intent, we perceive certain areas that could be improved.

First, the bill could result in the FERC allocating generating and production costs to an operating utility, which would have no method of recovering such costs from retail ratepayers if the state commission were to disallow them. That situation can be remedied by redrafting the bill so that upon any disallowance of the costs by a state commission, the allocation ordered by the FERC against the operating utility is rendered invalid. The parent holding company which caused the plant to be built would thus properly assume exposure for the disallowed costs.

As a result, operating utilities and their customers would receive protection from unwise investment decisions made by the parent company, and the latter would have a strong incentive to stop its circumvention of state regulation. Of course, should the parent company still wish to build multi-state projects for which the FERC would allocate costs, it would have that option and could appear before any affected state commission to argue the case for a flow-through of costs to retail customers. If the state commission were persuaded, then the allocation and its price would have been established as an FERC-approved wholesale rate.

Thus, a state could act to defeat holding company abuses if necessary, operating utilities would not be put in a squeeze between state and federal regulatory decisions, the FERC still would set wholesale power rates should a state commission approve the allocation, and the holding company bears the exposure if the state commission disapproves.

Second, S. 1149 permits a state commission not only to disapprove an allocation of generating costs, but also to modify the price of the power and other terms of the wholesale rate. Arguably, this thrusts the state commission into a role of setting wholesale power rates, as distinguished from determining the need for or prudency of the power allocation or purchase. The former role is better left to the FERC, while the latter authority certainly should reside with the states. Thus, S. 1149 could be modified to restrict state commission authority to the review of the prudency of an operating utility receiving the power allocation.

Third, there is no need to tie state jurisdiction over the prudency of power allocations or purchases to an absence of prior state approval of the project. State commissions nationwide routinely review the prudency of power purchases by jurisdictional utilities. Imprudent purchases are disallowed as a component of retail rates, and prudency jurisdiction is ongoing. This traditional approach should be applied to instances where a multi-state holding company seeks to have its operating utilities purchase power from the holding company system.

Fourth, although the language of the bill as drafted may cover costs associated with abandoned electric plants, new language could be added to make that point clear.

The above-discussed modifications can be made by adopting the following language to replace lines 3 through 24 of Page 2 of S. 1149. The new language is underlined:

> "(2)(A) Notwithstanding any other provision of this Act, if --
>
> "(i) a rate or charge fixed or permitted to take effect by the Commission is --
>
> "(I) applicable to the transmission or sale of electric energy subject to the jurisdiction of the Commission by an associate company of a public utility holding company system to any other associate company of such system; and
>
> "(II) based in whole or in part upon an allocation of electric energy or costs of production of electric energy from a generating unit or upon an allocation of costs of an abandoned or cancelled generating unit,

then each State commission which has jurisdiction over the associate company receiving or purchasing the electric energy or being allocated such production or other costs may determine the prudency of such company receiving or purchasing the electric energy or being allocated such production or other costs and, if such State commission denies such purchases or cost allocations pursuant to its review of prudency, then the rate or charge shall not be effective as to such associate company."

On another point, S. 1149 as drafted applies retroactively as of May 1, 1985. This retroactivity would permit the Arkansas, Louisiana and Missouri Public Service Commissions, having never approved the Grand Gulf nuclear plant, to reject the FERC allocation of costs approved in Middle South Energy, 31 F.E.R.C. ¶ 61,305 (1985). Undoubtedly, legal disputes will arise as to whether Congress can empower those state commissions to order their jurisdictional utilities to refund Grand Gulf-related rate increases granted in 1985, assuming the state commissions decided to give no effect to the FERC allocation. Regardless of who has the better argument on that point, we would submit that if the bill made no mention of retroactivity but did clarify the prospective authority of state commissions to determine the prudency of purchases or allocations, then from and following the effective date of the bill state commissions could begin ruling on prudency and deny Grand Gulf-related purchases or allocations in the future. Under this approach, the operating utilities would not be required to refund Grand Gulf-related rate increases collected prior to enactment of the bill, but thereafter state commissions, upon proper hearing of prudency issues, could reject the cost allocations if supported by the evidence under state law.

The latter approach may be illustrated by analogy to traditional ratemaking by state commissions. For instance, assume a state commission in one rate order has approved a particular methodology for the calculation of monthly fuel adjustment charges by a jurisdictional electric utility. In a subsequent rate order, that methodology could be modified resulting in a prospective loss of revenues to the utility, although refunds would not be ordered for charges made pursuant to the previously-approved methodology. Or, the state legislature might enact a change in the methodology causing the utility commission to reduce the charges prospectively.

While our consumer coalition would prefer retroactive application of S. 1149, we believe prospective application avoids much of the legal controversy related to retroactivity.

Accordingly, Section 3 of the bill at lines 5 through 8 might be modified to read:

> Sec. 3. The amendments made by this Act shall apply to any rate or charge fixed or permitted to take effect by the Federal Energy Regulatory Commission, whether such rate or charge was approved before or after the effective date of this Act, provided that such application shall be prospective from and after such effective date.

Mr. Chairman and Subcommittee members, our consumer coalition urges you to consider seriously S. 1149 and the amendments recommended herein. Many of you to date may not have encountered the abuses of electric utility holding companies as we in Arkansas have experienced recently. But rest assured that you will in the future if Middle South Utilities is permitted to blaze the trail around legitimate state regulation of the need for power and retail electric rates.

On a final point, we would highlight that Arkansas Power and Light Company has maintained before the FERC its desire to have no allocation of power from the Grand Gulf plant. Given that position, we believe AP&L, to be consistent, should support S. 1149 as we would amend it, since the amendments eliminate the risk of AP&L being ordered to pay for a share of Grand Gulf while unable to flow through that share to retail ratepayers. Also, the amendments cause a prospective application of the bill so that refunds would not be required. To our best knowledge, such changes should satisfy the two major concerns of AP&L against the bill as drafted. If AP&L declines to support the amendments, we would submit that its motivation is to protect Middle South Utilities, rather than itself and retail ratepayers in Arkansas.

Thank you again for this opportunity to file comments.

Senator **Bumpers**. Rush Dozier, who is a member of the Kentucky Public Service Commission, has to catch a 4 p.m. flight this afternoon, and I would hope that we could move him up to earlier testimony so that he would not miss that flight. His testimony, I know, is very important to the Senator from Kentucky, as it is to me, and if we could arrange that I would be most grateful.

Senator **Murkowski**. He is witness No. 5 on panel 4. He is next to last, so I would be happy to move him up to an appropriate position. Perhaps upon the completion of panel 1 we could accommodate him there.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator **Bumpers**. Now, Mr. Chairman, just for the edification of the committee and for the record, I would like to do two things. First, I would like to state the history of the regulation of electrical generating companies in this country and second, I want to explain what has happened in the *Grand Gulf* case, which can happen in many more cases to both States that are served by subsidiaries of holding companies and by utilities that are not part of the holding company but which might enter into a consortium with others to build generating capacity.

Until 1927 electrical power was all regulated by the State regulatory agencies. In 1927 the Supreme Court ruled that this was a burden on interstate commerce and that the States may no longer regulate the sale of power which traveled interstate.

In 1935 the Federal Power Act was passed, and the Federal Power Commission was established. One of the Federal Power Commission's chief duties was to set rates of sales of power and interstate commerce where the power was sold at wholesale. That is the beginning of why we are here today.

Bear in mind in 1935 that the Federal Power Commission, which is now the Federal Energy Regulatory Commission, began to regulate interstate wholesale sales of electricity.

In 1965 there was a decision by the Supreme Court in the *Colton* case which said not only will FERC have the authority to regulate rates for the wholesale sale of power interstate, but they shall have the power to regulate wholesale rates everywhere, whether the sale is intrastate or interstate. That gave FERC considerably greater power and greater latitude and much more authority.

Then, in 1977 the Rhode Island Supreme Court, in what we call the *Narranganset* decision, said that not only may FERC set rates at the wholesale level, but once they establish a rate for generating capacity at the wholesale level, the State regulatory authority may not question the reasonableness of that rate. The U.S. Supreme Court most recently affirmed the *Narranganset* rationale in the May 1986 *Nantahala* decision.

We have a holding company in my part of the woods called Middle South Utilities. There are four operating company subsidiaries: Arkansas Power & Light; Louisiana Power & Light; New Orleans Public Service; and Mississippi Power & Light. Early on in 1973 there was an agreement between all those subsidiaries that nuclear generating plants would be built which we commonly refer to now as Grand Gulf I and II.

What happened, then, was Mississippi Power & Light Co. went before the Mississippi Public Service Commission and asked for a certificate of convenience and necessity to build those plants; 6 months later it became apparent that Mississippi could not afford to do it. They were going to be very expensive even the original estimates. Incidentally, we have about a 500-percent cost overrun.

Then, the certificate at that point was transferred from Mississippi Power & Light to a subsidiary which was set up by Middle South Utilities called Middle South Energy. Now, you should also bear in mind that Middle South Energy has never had a single employee. They have never had anyone. It was a paper tiger, and it was formed for the specific purpose of arranging financing to build Grand Gulf.

It might also be good to point out here that one of the reasons the Public Utility Holding Company Act of 1935 was passed was to simplify holding company structures, to prohibit nonutility subsidiaries and to make sure that holding companies no longer built generating capacity and imposed some outrageous rate on their subsidiaries by making them take the power.

In any event, they formed a subsidiary, Middle South Energy, to build the plants. Construction, after financing was arranged, started. So, Mr. Chairman, the reason we are here today is because FERC has taken a $3.5 billion plant and allocated that power to those four subsidiaries. Two of the States utility commissions, Louisiana and Arkansas, and the New Orleans Public Service Commission were never so much as asked by your leave before that plant was built.

Today, nationwide there is an excess generating capacity of 30 percent. As a result of Grand Gulf, however, in Arkansas, one of the poorest States in the Nation, there is a 65-percent excess of generating capacity. In Mississippi, the poorest of all the States, there is a 100-percent excess of generating capacity.

The FERC, in my opinion, went through all kinds of convoluted logic in their decision. I read it again the other day. It was just as unbelievable to me the second time as it was the first time. They went through all kinds of convoluted logic, in my opinion, to reach a decision which was designed to keep Middle South from going broke.

That is a perfectly laudable purpose, I suppose, if it were not for the fact that it imposed such an unbelievable, outrageous burden on people from some of the poorest States in the Nation. For the first time in history, FERC ordered a utility to purchase power. It is not uncommon at all to order somebody to sell power, but for the first time in history FERC ordered these subsidiaries to buy power.

FERC will argue with that, but the truth is they allocated the cost of Grand Gulf so that the effect of it is the same. They ordered them to buy power.

In addition to that, in the original agreement in 1973 the subsidiaries all said if this plant is built, we will take whatever our needs are. Now, at that point no one could have objected. Their predictions were that they were going to continue to have a 6-, 7-, 8-percent annual increase in demand over the next several years.

In addition to that, there were some representations made that I think ought to be put in the record. They are not terribly relevant to the legislation, but I think it ought to be said.

First of all, when they got the certificate from the Mississippi Public Service Commission, Mississippi Power & Light told the Public Service Commission of Mississippi that they would only be required to take what they needed; 4 years later, in 1977, our present Gov. Bill Clinton, who was then attorney general, asked Floyd Lewis, who was then president of Middle South Utility: "Are we going to have to take any of Grand Gulf?" Floyd Lewis said: "Not unless we need the power."

Now, those were the kinds of representations that were made in order to get this plant built. No wonder the States thought everything was going to come out hunky-dory.

In any event, in addition to requiring subsidiaries to purchase power for the first time in history, FERC did something else. FERC went through a convoluted process of saying that they were going to order production cost equalization of all nuclear power in the Middle South system. That had two effects.

No. 1, Arkansas had planned very wisely early in the 1970's to build nuclear plants, what we call ANO I and ANO II. It is comparatively cheap power. By directing that all subsidiaries will pool all their nuclear generating capacity, what they are saying is we must sell in Arkansas to the other subsidiaries our cheap ANO I and ANO II and buy the most expensive power of all, namely Grand Gulf. So we got a double-whammy.

Second, we got assigned 36 percent of the Grand Gulf plant, or 33 percent of the 90 percent that Middle South owned plus having to give up the cheap power that Arkansas Power & Light Co. had very wisely provided for our people early on, and we had to pay for the most expensive power Middle South generates.

So, Mr. Chairman, consultants have cropped up all over this country now to tell utilities how to bypass the State regulatory authority. Go right to FERC, who never met a utility it did not like, who has never excluded from a rate base in the past 6 years one dime of construction costs.

The Supreme Court ruled early on, and every lawyer learns it in law school, that the power to tax is the power to destroy. I can tell you that the power of FERC to impose these kinds of burdens on the people of these States arbitrarily, capriciously, and without us ever having any input into whether we wanted the power, whether we could afford the power, is also the power to destroy our respective States. I am speaking for my State and the other States.

My bill, Mr. Chairman, of which Senator Pryor is an original and active cosponsor, is a very simple bill. It simply says that when one subsidiary of a holding company sells power to another subsidiary of that holding company at wholesale rates, and a rate for that generating capacity is set by FERC, unless the purchasing subsidiary has first gotten permission from the State regulatory authority which normally regulates them, that regulatory authority shall not be under compunction or mandate to pass on any or all of the costs of that plant.

Now, there will be an argument made by someone here from Middle South this afternoon saying that this bill is unconstitutional. I will debate that at the time, but my point is very simple. It is not unconstitutional. The Congressional Research Services checked this very carefully for us. They conclude that it is not unconstitutional. The CRS analysis will be put in the hearing records.[1]

It might be unconstitutional if the States refuse to passthrough any construction costs. That might constitute a taking and violate the due process clause, but the utility can raise that issue at that point. On the face of this bill, it is not unconstitutional.

So States who are not even served by holding companies, you had better beware, too, of the implications of FERC's *Grand Gulf* decision. If you have a utility company in your State and they decide to form a consortium or pool with utility companies from other States to build generating capacity, you just bear one thing in mind. They can go straight to FERC and get all the authority they want to build it, and FERC may force your utility to purchase a larger share and your State public service commission will never have anything to say about it until the rate has been set. At that point, the State under the *Narragansett* doctrine will have to pass all of those charges on. Peter Bradford, I think, will testify to this this afternoon.

All we are trying to do is to get State rights back, give our States a chance to say on the front end before FERC commits our people to over $1 billion, that we need the power, that we can afford the power.

We are setting up a procedure with this bill. We are not imposing anything that is confiscatory. We are simply saying, if you want us to pass FERC's rates on, you better come to see us first before you obligate the people of my State or any other State to over $1 billion.

Thank you, Mr. Chairman.

[The analysis prepared by the Congressional Research Service follows:]

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[1] The analysis appears following Senator Bumpers' remarks.

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S. 1149, 99TH CONG., 1ST SESS. (1985): CONSTITUTIONAL IMPLICATIONS OF A PROPOSAL TO AMEND THE FEDERAL POWER ACT TO PERMIT STATES TO REVIEW FEDERALLY-APPROVED WHOLESALE RATES

Robin Jeweler
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June 20, 1986

EXECUTIVE SUMMARY

S. 1149, 99th Cong., 1st Sess. (1985) would, if enacted, amend the Federal Power Act, 16 U.S.C. § 791a et seq., to permit a state public utility commission setting intrastate retail rates not to take into account "all or part of" a wholesale rate established by the Federal Energy Regulatory Commission (FERC). The authority of the state to review the federally-approved wholesale rate would only apply to rates applicable to the transmission or sale of power by an associate company of a public-utility holding company to another associate company; to rates based upon an allocation of power or the costs of production of power; and, to sales to a jurisdictional utility whose state commission had not approved construction of the generating facility. Although limited in scope, the proposal would dramatically alter the long established relationship between state and federal jurisdiction to establish wholesale and retail rates.

This report considers the constitutionality of this proposal under the commerce clause and the due process clause of the Fifth Amendment to the United States Constitution. It concludes that on its face the statutory language suffers no constitutional infirmity. Although it could open the door to state action which ultimately compromises the due process rights of regulated utilities, those problems are only speculative and must be resolved on a case-by-case basis.

S. 1149, 99TH CONG., 1ST SESS. (1985): CONSTITUTIONAL IMPLICATIONS OF A PROPOSAL TO AMEND THE FEDERAL POWER ACT TO PERMIT STATES TO REVIEW FEDERALLY-APPROVED WHOLESALE RATES

S. 1149, 99th Cong., 1st Sess. (1985), would, if enacted, dramatically alter the relationship between state and federal jurisdiction to establish wholesale and retail rates for the sale of electricity among associate companies of a public-utility holding-company system. This report considers the constitutionality of this proposal under the commerce clause and the due process clause of the United States Constitution. It concludes that on its face the statutory language suffers no constitutional infirmity. Although the proposal could ultimately facilitate state action which compromises the due process rights of a regulated utility, that possibility would require a case-by-case analysis of the state action in question.

BACKGROUND

S. 1149 would amend the Federal Power Act, 16 U.S.C. § 791a *et seq.* to permit state public utility commissions (PUC's) to reconsider and recalculate wholesale rates set by the Federal Energy Regulatory Commission (FERC) in establishing intrastate retail rates. More precisely, the state PUC could "make a determination not to take into account all or part of" a wholesale rate established by FERC that meets the following criteria: First, the rate is applicable to the transmission or sale of electric energy by an associate company of a public-utility holding company to another associate company. Second, the rate is based in whole or in part upon an allocation of electric energy or the costs of production of electricity. And, third, the associate company receiving, purchasing, or being allocated the production costs of the electric energy is subject to the jurisdiction of a state commission which had not approved the construction of such generating unit.

Despite the generic statutory language, S. 1149 is directed at situations such as that which has recently arisen in connection with FERC's allocation of power from the Grand Gulf Nuclear Electric Generating Station. Grand Gulf is owned by Middle South Utilities, Inc. (MSU), a public-utility holding company registered under the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 *et seq.*[1]

In a series of administrative decisions culminating in Opinion No. 234,[2] FERC reformed sales agreements among associate companies of the Middle South system in order to achieve production cost equalization for Grand Gulf. Among the MSU subsidiaries are four operating companies[3] which are subject to the jurisdiction of both their respective state PUC and FERC. The practical effect of FERC's ratemaking methodology is to shift responsibility for a substantial portion of rate base calculation, previously subject to the state PUC, to the jurisdiction of FERC.

Pursuant to the Federal Power Act,[4] FERC has plenary jurisdiction to establish rates for the sale and transmission of power at wholesale in interstate commerce. *Federal Power Comm'n v. Southern California Edison,*

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[1] 131 *Cong. Rec.* S 6307-11 (daily ed. May 16, 1985)(statements of Sen. Bumpers and Sen. Pryor).

[2] Opinion No. 234; Opinion and Order Setting Just, Reasonable and Non-Discriminatory Rates, 31 FERC ¶ 61,305 (June 13, 1985), *rehearing denied*, 32 FERC ¶ 61,346 (Sept. 3, 1985), *appeal docketed sub nom. Mississippi Industries v. FERC*, No. 85-1611 (U.S.Ct. of App., D.C. Cir. 1986).

[3] The operating companies are Arkansas Power and Light, Louisiana Power and Light, Mississippi Power and Light, and New Orleans Public Service, Inc.

[4] 16 U.S.C. § 824.

376 U.S. 205 (1964); Northern States Power Co. v. Minnesota, 344 N.W.2d 374 (Minn.), cert. denied 104 S.Ct. 3546 (1984). In order to calculate just, reasonable and non-discriminatory rates,[5/] FERC asserts jurisdiction over that portion of a generating facility dedicated to the production of power for sale at wholesale in interstate commerce.

Historically, the states have and, consistent with the Federal Power Act, they retain jurisdiction to establish retail rates for intrastate sales of power. Cities of Batavia, et al v. FERC, 672 F.2d 64, 68 n.2 (D.C.Cir. 1982). However, pursuant to the Supremacy Clause of the United States Constitution and principles known as the "filed rate" and "Narragansett doctrine" after Narragansett Electric Co. v. Burke, 119 R.I. 559, 381 A.2d 1358 (1977), cert. denied, 435 U.S. 972 (1978), states are required to accept the reasonableness of the FERC-approved wholesale rate, regardless of whether it is premised on contract rates, purchased power rates as a component of operating expense, or allocation of entitlement power, and pass it through to the state-approved retail rate. Nantahala Power & Light Co. v. Thornburg, __ U.S.L.W.____ (U.S. June 17, 1986)(No. 85-568); Montana-Dakota Utilities, Inc. v. Northwestern Public Service Co., 341 U.S. 246 (1951); Eastern Edison Co. v. Dept. of Pub. Utilities, 388 Mass. 292, 446 N.E.2d 684 (1983); Northern States Power Co. v. Minnessota Pub. Serv. Comm'n, 344 N.W.2d 374 (Minn.), cert. denied, 104 S.Ct. 3546 (1984); Appeal of Sinclair Machine Products, Inc., 498 A.2d 696 (N.H. 1985); Northern States Power Co. v. Hagen, 314 N.W.2d 32 (N.D. 1981); See also, Hobelman, The Narragansett Decision and Its Aftermath, 6 Energy L. J. 33 (1985).

[5/] 16 U.S.C. §§ 824d, 824e.

The dual system of state and federal regulation of public utilities has been in place since passage of Part II of the Federal Power Act, 16 U.S.C. § 824 *et seq.*, in 1935. But tension between the respective regulatory spheres has increased with the advent of nuclear powered generating facilities. The extent to which ratepayers should reimburse an investor-owned utility for construction costs of a nuclear facility which comes on line at great cost, or is cancelled after great cost, raises controversial issues which have received diverse regulatory treatment in the past.[6/] These large ratepayer expenses have led the states, in many instances, to seek greater control over the flow-through of costs incurred in connection with these facilities to ratepayers. When an increasingly large share of these plants' output is dedicated to wholesale sales in interstate commerce, however, the states lose, proportionately, jurisdiction to regulate the extent to which the costs of production of these facilities were prudently incurred and must be passed on to residential ratepayers; these findings are made by FERC and must be accepted by state PUC's.

In the Grand Gulf nuclear powerplant proceedings, discussed *supra*, a FERC administrative law judge (ALJ) essentially found that, despite

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[6/] FERC-approved and allocated costs for abandonment of the Tyrone nuclear powerplant owned by Northern States Power led to a great deal of litigation. Both the state and federal courts which were presented with the question held that the state PUC's were required to accept the FERC-approved rates. *See*, 17 FERC ¶ 61,196 (1981), *aff'd*, *South Dakota Pub. Utilities Comm'n v. FERC*, 690 F.2d 674 (8th Cir. 1982); *State of Minnesota v. FERC*, 734 F.2d 1286 (8th Cir. 1984); *Northern States Power v. Minn. Pub. Serv. Comm'n*, *supra*; *Northern States Power Co. v. Hagen*, *supra*.

See also, Energy Information Administration, *Nuclear Plant Cancellations: Causes, Costs, and Consequences* 1983; Rodgers and Gray, *State Commission Treatment of Nuclear Plant Cancellation Costs*, 13 Hofstra L. Rev. 443 (1985).

agreement among MSU subsidiaries to the contrary, the Grand Gulf powerplant is a shared system resource, and the ALJ allocated power therefrom accordingly to the MSU operating subsidiaries. Another ALJ found that it was within FERC's jurisdiction to order production cost equalization for all the generating capacity in the Middle South system -- which would have shifted as much as 75% of rate base to FERC jurisidiction -- but declined to do so.[7]

It is against this backdrop that S. 1149 must be considered. The statute would permit a state PUC not to take into account all or part of a wholesale rate set by FERC for transmission or sale of power among holding-company system associates. Consequently, the states would be free to reexamine and adjust a FERC-approved rate. They would be permitted to scrutinize the fundamental components for arriving at the costs of production and service, e.g., prudence, construction work in progress, and amortization of costs of an abandoned plant.[8] Hence, operating company subsidiaries of a public-utility holding company will be subject to a new step in the determination of rates: state review of federally-fixed wholesale purchased power rates for intrastate, retail ratemaking purposes. Discussed below are constitutional questions which may arise in connection with this new regulatory scheme.

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[7] 30 FERC ¶ 63,030 at 65,149, 65,151 (Feb. 4, 1985).

[8] It is not entirely clear whether state PUC's would be permitted to review FERC decisions allocating cancellation costs for an abandoned nuclear powerplant under S. 1149, although it would seem that they may. The statute gives the state jurisdiction over wholesale rates when "based in whole or in part upon an allocation of electric energy or costs of production" of electricity. Technically, cancellation costs are treated as a "cost of service" as opposed to a cost of production. See, e.g., Initial Decision on Nuclear Plant Cancellation Loss, 13 FERC ¶ 63,049 (Dec. 4, 1980) allocating cancellation costs for the Tyrone nuclear plant among associate companies of Northern States Power Co. But shared cancellation costs are arguably allocation of power costs. Since the statute grants a state jurisdiction over the entire wholesale rate when jurisdictional requirements are met, it would be consistent with the statute's intent to construe the jurisdictional grant broadly.

DOES THE COMMERCE CLAUSE PROHIBIT STATE REVIEW OF FEDERALLY FIXED WHOLESALE RATES?

The commerce clause grants Congress the power to regulate commerce among the states. U.S. Const., Art. I, § 8, cl. 3. In 1927, the United States Supreme Court held states may not burden interstate commerce by setting wholesale rates for interstate sales of power. Public Utilities Comm'n v. Attleboro Steam & Elec. Co., 273 U.S. 83 (1927); Cf., Arkansas Elec. Cooperative Corp. v. Arkansas Public Service Comm'n, 461 U.S. 375 (1983). More recently, the Court has noted that "the commerce power permits Congress to pre-empt the States entirely in the regulation of private utilities." FERC v. Mississippi, 456 U.S. 742, 764 (1982). Congress' authority to regulate private utilities, however, does not constrain it from conferring express authority on the states to regulate in its stead.

Insofar as the commerce clause is concerned, the cases are definitive that Congress may authorize the states to enact regulations or prohibitions that in the absence of affirmative federal authorization would constitute violations of that clause. Pennsylvania v. Wheeling & Belmont Bridge Co., 18 How. (59 U.S.) 421 (1856); In re Rahrer, 140 U.S. 545 (1891); Clark Distilling Co. v. Western Md. Ry Co., 242 U.S. 311 (1917); United States v. Pub. Utilities Comm'n of Calif., 345 U.S. 295 (1953). When, for example, the Court ruled that insurance transactions across state lines constituted interstate commerce, United States v. Southeastern Underwriters Assn., 322 U.S. 533 (1944), it established a basis for voiding discriminatory state taxing laws; thereafter, Congress passed a law authorizing state regulation and taxation of the business of insurance. In sustaining a state law which imposed on foreign insurance companies, as a condition of doing business in the state, an annual tax which was not imposed on local corporations, the Court acknowledged that while a state acting alone may not discriminate against interstate commerce or favor local commerce as against interstate commerce, no such restraint exists with respect to Congress' power under the commerce clause. Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 423 (1946). That power may be exercised by Congress alone, or in coordination with the states, but in either instance the power to regulate interstate commerce is limited only by alternate constitutional limitations:

> The power of Congress over commerce exercised entirely without reference to coordinated action of the states is not restricted, except as the Constitution expressly provides, by any limitation which forbids it to discriminate against interstate commerce and in favor of local trade. Its plenary scope enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons. . .
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> This broad authority Congress may exercise alone, subject to those limitations, or in conjunction with coordinated action by the states, in which case limitations imposed for the preservation of their powers become inoperative and only those designed to forbid action altogether by any power or combination of powers in our governmental system remain effective.
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> (Footnotes omitted.)
> Id. at 434-435.

More recently, the United States Supreme Court has had frequent occasion to express the oft-cited principle that "[w]hen Congress so chooses, state actions which it plainly authorizes are invulnerable to constitutional attack under the Commerce Clause." Northeast Bancorp, Inc. v. Board of Governors,

___ U.S. ___, 105 S.Ct. 2545, 2554 (1985); South-Central Timber Development, Inc. v. Wunnicke, 467 U.S. 82 (1984); White v. Mass. Council of Construction Employees, 460 U.S. 204 (1983); New England Power Co. v. New Hampshire, 455 U.S. 331 (1982); Western & Southern Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648 (1981); See also, Middle South Energy, Inc. v. Arkansas Pub. Service Comm'n, 772 F.2d 404 (8th Cir. 1985).

S. 1149 would operate as an express Congressional authorization for a state public utility commission, in specified circumstances, not to take into account all or any part of a federally-approved wholesale rate for the purpose of setting intrastate rates. It would mark the departure from the demarcation between federal and state jurisdiction to establish wholesale power rates established by the U.S. Supreme Court in Attleboro Steam & Elec. Co., supra, and perpetuated by Congress and the courts under the Federal Power Act. On its face, this provision does not appear to impose a direct burden on interstate commerce since it is ultimately concerned with intrastate rates. Nevertheless, even assuming that a state ratemaking action pursuant to the authorization would impose either a direct or an indirect burden on interstate commerce, applying the principles enunciated by the U.S. Supreme Court above, such activity appears to be invulnerable to constitutional attack on commerce clause grounds.

DOES THE DUE PROCESS CLAUSE OF THE FIFTH AMENDMENT PROHIBIT RETROACTIVE APPLICATION OF S. 1149?

Section 3 of S. 1149 provides that its provisions shall apply to rates or charges fixed or permitted to take effect pursuant to a final order issued by FERC on or after May 1, 1985. Hence, a state commission would be authorized to make retroactive adjustment to a final FERC-approved wholesale rate.[9]

It is well established that, under the Federal Power Act, 16 U.S.C. § 824e, FERC may prescribe electric power rates prospectively only, not retroactively. FPC v. Sierra Pacific Power Co., 350 U.S. 348, 353 (1956); Pub. Serv. Co. of New Hampshire v. FERC, 600 F.2d 944 (D.C. Cir.), cert. denied, 444 U.S. 990 (1979). The prohibition against retroactive rates, however, appears to be premised on the statutory language of 16 U.S.C. § 824e(a), that "the Commission shall determine the just and reasonable, rate. . . to be thereafter observed," not upon guarantees of due process embodied in the Fifth Amendment to the U.S. Constitution.

Indeed, the Court has expressed tolerance for retroactively applied economic legislation, provided it is supported by rational legislative purpose. Pension Benefit Guaranty Corp. v. Gray & Co., 467 U.S. 717 (1984); Usery v. Turner Elkhorn Mining Co., 428 U.S. 1 (1976). Cf. Connolly v. Pension Benefit Guaranty Corp., ___U.S.___, 106 S.Ct. 1018 (1986).

In the Gray decision, the Court upheld retroactive application of employer withdrawal liability provisions of the Multiemployer Pension

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9/ FERC's final order in the Grand Gulf proceedings, supra note 2, is dated June 13, 1985.

Plan Amendments of 1980. The liability provisions were extended to apply during a five-month period prior to the statute's enactment. The Court specifically rejected the four-part test for judicial review of retroactive federal legislation relied upon by the lower courts in Nachman Corp. v. Pension Benefit Guaranty Corp, 592 F.2d 947 (7th Cir. 1979), aff'd on statutory grounds, 446 U.S. 359 (1980), which required a court to examine (1) the reliance interest of the affected parties, (2) whether the interest impaired is in an area previously subjected to regulatory control, (3) the equities of imposing the legislative burdens, and (4) the statutory provisions that limit and moderate the burdens imposed. 467 U.S. at 727, note 6. Instead, the Court cited Usery, supra, as a starting point for its analysis, quoting from it the proposition "'It is by now well established that legislative Acts adjusting the burdens and benefits of economic life come to the Court with a presumption of constitutionality, and that the burden is on one complaining of a due process violation to establish that the legislature has acted in an arbritrary and irrational way.'" Id. at 729.

The Court continued to rely on the analysis set forth in Usery, supra, but clarified the scope of limited judicial review accorded economic legislation under the due process clause of the Fifth Amendment:

> To be sure, we went on to recognize that retroactive legislation does have to meet a burden not faced by legislation that has only future effects. "It does not follow. . . that what Congress can legislate prospectively it can legislate retrospectively. The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former." Id., [Usery] at 16-17. But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.
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> Id. at 730.

Faciliting effective state regulation of public-utility holding-company subsidiaries was a primary goal of Congress when it enacted the Public Utility Holding Company Act, 15 U.S.C. § 79 *et seq.*[10/] in 1935. Assuming that granting states jurisdiction to review a utility holding-company subsidiary's purchased power costs for the purpose of establishing just and reasonable retail rates is a legitimate legislative goal supported by rational legislative purpose, extending that authority retroactively to encompass recent ratemaking proceedings is arguably rational as well. On that basis, S. 1149 appears to meet the *prima facie* burdens imposed by due process considerations for retroactive legislation.

Less clear, however, are the constitutional implications of state action which may be predicated on authority granted under S. 1149. Although an exhaustive analysis of consequences of the myriad possible state ratemaking actions is beyond the scope of this report, some observations are in order.

CONSTITUTIONAL IMPLICATIONS OF STATE ACTION PURSUANT TO S. 1149

S. 1149 would operate as a statutory exception to the many principles, discussed above, which establish the primacy of federal wholesale rates under the Federal Power Act over state ratemaking procedures. But its ultimate impact on retail intrastate rates is neutral -- the states are left to implement the law. A state PUC exercising the newly conferred authority

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[10/] 15 U.S.C. § 79k. *See*, S. Rep. No. 621, 74th Cong., 1st Sess. (1935); H.R. Rep. No. 1318, 74th Cong., 1st Sess. (1935); and, H.R. Rep. No. 1903, 74th Cong., 1st Sess. (1935).

"not to take into account all or part of any" federally-approved rate must continue to operate within the constraints imposed by the Fourteenth Amendment to the U.S. Constitution against utility rates which are confiscatory takings of property in violation of due process and equal protection of law. *Bluefield Water Works & Improvement Co. v. Pub. Service Comm'n*, 262 U.S. 679 (1923); *Missouri ex rel. Southwestern Bell Telephone Co. v. Pub. Service Comm'n*, 262 U.S. 276 (1923); *Minnesota Rates Cases*, 230 U.S. 352 (1913); *Smyth v. Ames*, 169 U.S. 466 (1898).

That the states must comply with the constitutional proscription against confiscatory rates is self-evident. Congress cannot confer the power to violate the constitution. Nevertheless, Congressional intent respecting the statute's application would have a bearing on any judicial inquiry into its constitutionality as applied. The scant legislative history of S. 1149 to date suggests Congress recognizes that the bill permits states to make determinations beyond whether to merely pass through or deny the FERC wholesale rate:

> This legislation would not interfere with whatever final decision is made by the FERC. It would merely allow the Arkansas Public Service Commission--or the Louisiana Public Service Commission in the Grand Gulf case for that matter--to consider what portion of those rates, if any, should be flowed through to consumers and under what circumstances. The State commission's decision would still be subject to constitutional prohibitions against confiscatory rates, but our bill would allow the State commission the opportunity to make an independent determination whether the utility's costs should be passed on to ratepayers and, if so, to what extent. 11/

11/ 131 *Cong. Rec.* S 6310 (daily ed. May 16, 1985)(Statement of Sen. Bumpers.)

Indeed, the state PUC's have a long tradition of utility regulation and must be presumed to have expertise in ratemaking that would lend itself to reviewing and adjusting a FERC-approved wholesale rate consistent with well established constitutional guidelines for establishing "just and reasonable" rates.[12/] *See*, *Bluefield Water Works & Improvement Co.*, *supra*. Hence, despite the fact that the Arkansas Public Service Commission has vigorously contested FERC's allocation of Grand Gulf output, *see e.g.*, *Middle South Energy, Inc. v. Arkansas Pub. Service Comm'n*, 772 F.2d 404 (8th Cir. 1985), an administrative action which simply fails to pass through the cost of purchased wholesale power would appear to be an obvious breach of a jurisdictional utility's right to a "just and reasonable" rate. The federal grant of authority to the states under S. 1149 should not be construed as sanctioning punitive regulatory measures that would be inconsistent with currently acceptable legal standards of regulatory review.[13/]

The U.S. Supreme Court wrote, in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1943), "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed

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[12/] Problems for regulators and utilities alike are certain to arise when state commissions attempt to reconcile state laws and policies which conflict with federal law. Many states, for example, do not permit ratepayers to pay for costs associated with powerplant cancellations. State law may prohibit construction work in progress, or require that all plant be used and useful. *See*, *Appeal of Sinclair Machine Products, Inc.*, *supra*.; *Northern Indiana Pub. Service Co. v. Citizens Action Coalition*, 485 N.E.2d 610 (Ind. 1985), *cert. den.* 54 U.S.L.W. 3772 (U.S. May 27, 1986). This conflicts with FERC regulations. The means and fairness with which states resolve these problems will be assessed on a case-by-case basis.

[13/] In this regard it may be noted that only state commissions that have not approved construction of generating facilities would be allowed to review FERC wholesale rates. Failure to certify generating facilities, however, is but a jurisdictional factor, not the basis for a normative ratemaking standard.

which is controlling." A wholesale rate approved by FERC is not necessarily the only constitutionally permissible rate that a utility may hope to receive for that sale or transmission of power. S. 1149 would permit a state PUC to adjust or recalculate the federally-approved rate. The rates the states arrive at pursuant to that authority must comport with otherwise applicable constitutional protections for utilities. S. 1149, by virtue of permitting that exercise of authority by the states, does not appear to run afoul of the commerce clause or the due process clause of the Fifth Amendment to the U.S. Constitution.

Robin Jeweler
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June 20, 1986

Senator **Murkowski**. Thank you very much, Senator Bumpers.

I think in your opening statement you referred at least twice to the convoluted opinions from FERC. I assume you and Senator Ford, who are on the Energy Committee, would agree that since we are the committee that has the exclusive oversight of FERC, there has been a good deal of frustration associated with our inability to basically communicate with them.

Once the confirmation process occurs, and one can only wonder if it is not interlaced with a bureaucracy and a staff structure that makes it pretty difficult to continue congressional intent.

Trying to move FERC is like trying to poke a gopher out of a whole with a piece of rope, but unless we address in the confirmation process more of the theory behind the application of State rights, I am afraid we are going to remain frustrated.

I am sure my colleague from Kentucky may be able to tell you a better story or a better example, and he may have an opening statement at this time. We have had a little discussion about coal slurry pipeline this morning. I am afraid it put him in a rather——

Senator **Ford**. Raunchy mood.

Senator **Murkowski**. As far as I know, he has been in that mood ever since, and we will see, now.

Senator **Ford**. Mr. Chairman, I will decline to make any kind of opening statement.

There are two things I hope we will do, however. We should take heed to what Senator Bumpers has said, along with his distinguished colleague, Senator Pryor, on what they have in their legislation. I would very much like, Mr. Chairman, that we listen very closely, and those that would come in here charging this committee or anyone else should listen to Mr. Dozier's testimony and what has happened in Kentucky.

I think that what you will find that what we have done in Kentucky to fight, as you are in Arkansas, some effects are beginning to bear fruit, but everyone who has a lot of money always seem to find some way to get around the consumer. So I would ask you to be attentive when Rush Dozier gives his testimony.

Thank you, Mr. Chairman.

Senator **Murkowski**. Thank you.

Senator **Bumpers**. Mr. Chairman, I want to thank you for your remarks. This has just become a monster that is going to have to be reined in. They have taken on a life of their own. As you say, this committee has not been able to really come to grips with that yet.

Senator **Murkowski**. If we cannot handle it, and obviously we cannot, why then the question is who will? We better reflect on that.

I am going to move along and call Senator Pryor to the witness stand. At this time I will turn the committee chairmanship over to Senator Bumpers on a temporary basis.

Senator **Bumpers** [presiding]. Senator Pryor, thank you very much for coming.

STATEMENT OF HON. DAVID H. PRYOR, A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator PRYOR. Thank you, Senator Bumpers.

Mr. Chairman, let me begin by expressing my deep appreciation for your agreeing to hold hearings on S. 1149, the Ratepayer Protection Act of 1985, and for allowing me the opportunity to testify.

I believe that this bill is extremely important to utility ratepayers in all of the States and to Arkansas ratepayers in particular. It is my hope that these hearings will provide a positive, public record on S. 1149 that will translate into public support and eventual passage.

For the sake of brevity, Mr. Chairman, I will not go into a long description of the situation Arkansas ratepayers are facing. I will give only a very brief summary of the events that have moved me to introduce this legislation with Senator Bumpers.

As Senator Bumpers has mentioned in an earlier statement, in the early 1970's Middle South Energy, [MSC], a subsidiary of Middle South Utility, was established for one purpose, for the construction of nuclear plants. It began construction of two plants, Grand Gulf I and Grand Gulf II in the State of Mississippi.

Middle South Utility [MSU] is the parent company and has four operating companies, one of which is the Arkansas Power & Light Co.

Because the energy needs of Arkansas did not require any of the power produced by either of these plants, Arkansas Power & Light Co. was given a zero allocation of power and a zero allocation of costs.

In fact, in 1977 Mr. Floyd Lewis, then chairman of Middle South, stated to then attorney general and now our distinguished Governor, Bill Clinton, that Arkansas ratepayers would not have to pay for the construction costs of the electric power used by Louisiana and Mississippi as long as Arkansas did not use the electricity generated by Grand Gulf I and II.

In the 1970's, the Arkansas Power & Light Co. constructed its own power plants, paid for solely by the Arkansas ratepayers. Not one dime of the cost for construction in the State of Arkansas was paid for by the ratepayers in other States, nor did we in Arkansas ever expect them to pay.

The people of Arkansas could not believe it when, on February 3, 1984, the administrative law judge for the Federal Energy Regulatory Commission ruled that approximately one-third of the construction costs for the Grand Gulf plant, serving only Louisiana and Mississippi, would be borne by Arkansas ratepayers.

Then, something that should be included in Ripley's Believe It Or Not, on June 13, 1985, the full Federal Energy Regulatory Commission upheld the earlier decision of the administrative law judge.

This entire sordid, botched, and grossly unfair episode of Grand Gulf I and Grand Gulf II is unbelievable. The results are unthinkable.

The traditional and historic role of a State public service commission to review and pass upon utility rates imposed by its own consumers was denied in this process, preempted, and circumvented, and due process was obliterated by FERC's action.

Now, what happens to another white elephant, Grand Gulf II? It is 80 percent complete; $1 billion has been spent. Further construction has been halted. Now, will FERC decide that, yes, a poor business decision, another poor business decision has to be paid for by the innocent ratepayers of our State? Why is it that the stockholders of the utility companies, rather than the ratepayers, have to be accountable for poor business decisions?

In closing, along with the rest of the Arkansas congressional delegation, I have appealed the FERC decision allocating the cost of Grand Gulf. S. 1149 is not a complex bill, even though it deals with a complex issue. It is a bill that would prevent a State regulatory commission from being completely precluded from exercising its rightful historic and traditional authority of setting our State's electric rate.

The *Grand Gulf* case shows very clearly why this bill is needed. Arkansas ratepayers are realizing much higher utility bills today due directly to Grand Gulf. In fact, a recent study by the Tennessee Valley Authority shows that residential electricity bills in Little Rock are now the second highest among major cities in the Southeastern United States. They have gone up 14 percent since last summer. Little Rock residential rates rank only behind those in New York, and Detroit, and are comparable to those in Louisiana, in Los Angeles.

I began my statement by saying that S. 1149 is important to all ratepayers and to Arkansas in particular. I hope I have shown the particular importance of S. 1149 to my own State, but I also hope that my testimony has made it clear that any public service commission in any State can be prevented from exercising its historic rights by the Federal Energy Regulatory Commission unless such as the Ratepayer Protection Act is enacted to prevent it.

I thank the Chair very much and look forward to continuation with you.

Senator **BUMPERS**. Senator Pryor, thank you very much.

In the interest of time, Senator Ford and I are going to forgo questions. I ask unanimous consent at this point that Senator Pryor be permitted to sit with the committee during the pendency during the remainder of this hearing.

Governor Clinton, could I ask you to indulge one witness between Senator Pryor and you? I really think Mr. Dozier's testimony is very important, and I do not want him to miss his flight, if it is agreeable with you. Kentucky, as you know, knows firsthand what we are talking about, and I would like to get Mr. Dozier's testimony.

Mr. Dozier, you are our next witness.

Senator **FORD**. Rush, just remember, it will be the first time and probably the last time you go ahead of a Governor.

STATEMENT OF RUSH W. DOZIER, JR., VICE CHAIRMAN, KENTUCKY PUBLIC SERVICE COMMISSION, ACCOMPANIED BY RICHARD RAFF, ATTORNEY, KENTUCKY PUBLIC SERVICE COMMISSION

Mr. **DOZIER**. I appreciate the committee's indulgence. With me today is Richard Raff, attorney with the Kentucky Public Service

Commission, who has handled our litigation with the American Electric Power System.

I have previously filed my testimony, Senator Bumpers, and I will just briefly summarize it.

I think the Kentucky experience shows the very dangers that you have mentioned, Senator Bumpers, and that Senator Ford has referred to as well; that is, the danger of forum shopping by a large, multistate holding company in order to get the best deal.

Senator **Bumpers**. Rush, excuse me. I hate to interrupt you but, you know, we lawyers talk about rush to the court house?

Mr. **Dozier**. Yes.

Senator **Bumpers**. Same thing exactly.

Mr. **Dozier**. Absolutely, and I think ours is perhaps one of the clearest cases because our case involved the American Electric Power System, which is one of the largest investor-owned, fully integrated grids in the world. It furnishes power to seven States, including Kentucky, and owns both generation, transmission and distribution facilities.

The American Electric Power System constructed a 1,300 megawatt plant in Rockport, IN, a coal-fired plant burning Wyoming coal. They sought to have the Kentucky Power Co., which is one of the wholly owned subsidiaries of the American Electric Power System, purchase 15 percent of that plant, saying that Kentucky Power needed that capacity.

Well, if you look at Kentucky Power alone, you might make an argument that they do need that capacity. As I said, the American Electric Power System is like one large utility company spreading over seven States. If you look at AEP as a whole, it has huge reserves. At the time of this litigation and our commission hearings, there were nearly 50 percent reserves, when a prudent utility has usually approximately 20 percent reserves. So, looked at as a whole, Kentucky Power and AEP did not need another large coal-fired base load plant.

The commission looked over very carefully AEP and Kentucky Power's application for purchase by the Kentucky Power System, and on August 2, 1984 we ruled that that would not be a prudent investment by Kentucky Power, that the power could be purchased for Kentucky Power through the AEP System at a much cheaper price, saving 148,000 consumers and ratepayers in the Kentucky Power service area about $23 million per year.

On that very day that we handed down that decision for bidding the purchase of 15 percent of the Rockport plant, August 2, 1984, AEP's attorneys filed with the Federal Energy Regulatory Commission a unit power agreement obligating Kentucky Power which, remember, is a wholly owned subsidiary, to purchase 15 percent of the capacity and energy of the Rockport plant.

What they did, in essence, was say if we cannot get it from the Kentucky Public Service Commission, we will get it from FERC. They then argued that under the *Narranganaett* doctrine we were obligated to do what we had refused to do on August 2, 1984; that is, pass through these extra $23 million in cost to our ratepayers.

We refused, after another hearing, and we have been in litigation with the American Electric Power System ever since. They have taken us to every forum they possibly can. We are now fighting a petition for certiorari from the U.S. Supreme Court, but we have been successful in every forum.

We won in the U.S. District Court. We won in the Sixth Circuit Court of Appeals. The court agreed to abstain and said that that was a matter of our judgment. We won in the Franklin Circuit Court of Kentucky, which said our decision not to require Kentucky Power to purchase 15 percent of this plant was, indeed, reasonable.

We are a relatively small commission. Our resources are strained. AEP is a multibillion dollar holding company, but this is a clear example of what we feel is a company's opportunity, given the confusion with the *Narraganset* doctrine and with the Pike County exception, which allows a State commission to decide whether the purchase of even a reasonable rate is prudent.

This confusion leads to difficulties and can lead to a situation in which public service commissions, in their statutory duty to protect ratepayers, can be overturned by a multistate company going to the Federal Energy Regulatory Commission.

S. 1149 begins to address this problem by giving the States an opportunity to find that the FERC rate is not necessarily reasonable for a State's ratepayers. We would suggest that the legislation be amended to include specific reference to the Pike County exception; that is, to allow States, very clearly, the opportunity to decide what is prudent for a utility to purchase and what is not prudent.

In other words, even if FERC says it is a reasonable rate and even if we agree, as a State commission, that that is a reasonable rate, are there alternatives? Where is the cheapest power available? That exception which is now in the law but has not been formally recognized by the Supreme Court, although it was referred to without decision in the recent *Nantahala Supreme Court* case, is a very important principle that we feel State commissions must have available to them in assessing these situations.

Again, a clear example of forum shopping and a clear example of an attempt to overturn State authority, legitimate State authority, by an appeal to the *Narraganset* doctrine and the Federal Energy Regulatory Commission.

[The prepared statement of Mr. Dozier follows:]

TESTIMONY OF VICE CHAIRMAN RUSH W. DOZIER, JR., KENTUCKY PUBLIC SERVICE COMMISSION

I appreciate having the opportunity to testify today on the relationship between state public service commissions and the Federal Energy Regulatory Commission, and the effect S. 1149 would have on that relationship.

In Kentucky, this issue has an immediate price tag: $23.3 million per year. That is the amount of money that 148,000 Kentuckians will be paying in unnecessarily higher electric bills if a huge multi-state holding company can, in the view of the Kentucky Public Service Commission, successfully manipulate the uncertainties in federal-state jurisdiction for its own ends. Much to the dismay of the holding company, the Kentucky PSC has thus far been victorious in both the federal and state courts. But our limited resources are being taxed to the utmost as the company presses to reverse these victories. The story of this legal and regulatory struggle has important implications for the regulation of the nation's electric industry.

My testimony is divided into three parts. First, a discussion of our litigation with the American Electric Power Company. Secondly, an analysis of the effect S. 1149 would have on this kind of litigation. Finally, some suggestions for national initiatives that should be considered, given the trends in the electric power industry.

American Electric Power Co. v. Kentucky PSC

American Electric Power Company (AEP) is a public utility holding company that carries out the generation, transmission, and distribution of electricity in portions of seven states: Kentucky, Ohio, Indiana, Michigan, Virginia, West Virginia, and Tennessee. AEP prides itself on having one of the largest and most sophisticated power grids in the world. The company has six major wholly owned utility subsidiaries, one of which -- Kentucky Power Company -- is regulated by the Kentucky Public Service Commission. Kentucky Power has approximately 148,000 customers in the northeastern part of our state.

In 1981, Kentucky Power filed an application[1] with the Kentucky PSC seeking authority to own 15 percent of a 1,300 megawatt generating plant then under construction by AEP near Rockport, Indiana. AEP burns coal from Wyoming at the now-completed Rockport generating plant. As with most integrated multi-state arrangements of this type, all AEP subsidiaries are parties to a pooling -- or interconnection -- agreement which governs the generating and transmission facilities each subsidiary provides to the power pool and specifies how the subsidiaries are to share in these facilities. Kentucky Power's application to purchase 15 percent of the Rockport plant was based on two contentions: the company's alleged need for additional generating capacity and the company's alleged inability to meet that need by purchasing capacity under the pooling agreement.

Witnesses for Kentucky Power testified that, because of an implied obligation under the pooling agreement, the company was prohibited from continuing to purchase power from the pool. Consequently, the company argued that the purchase of a portion of the Rockport plant was its only available source of supply for additional power.

Because of a series of complex judicial appeals, the case dragged on for several years. During this time, the Kentucky PSC exhaustively explored every issue involved. To our surprise, we found that nowhere in the interconnection agreement was there an obligation, implied or explicit, to provide power to the pool equal to a member's load plus a reserve margin. Thus, there was no reason to stop buying power from the pool -- power that was much cheaper than the power from the Rockport plant. In addition, we concluded that Kentucky Power's claim to need additional generating capacity was highly misleading. No AEP subsidiary operates independently. Instead, the facilities of all AEP subsidiaries are centrally operated as if they collectively formed one huge utility. We found that, taken together, the subsidiaries had a combined reserve margin of nearly 50 percent. In contrast, the general standard in the industry is for a prudent utility to have a reserve margin of approximately 20 percent. Looked at as a whole (a perspective to which AEP and Kentucky Power vigorously objected), the AEP system -- even without the Rockport plant -- had an enormous reserve available to produce power for any subsidiary that might need it.

Not surprisingly, the Kentucky PSC ultimately denied Kentucky Power's bid to purchase 15 percent of the Rockport plant. Yet on the same day we issued our opinion -- August 2, 1984 -- AEP filed a unit power agreement with the FERC, an agreement that called for AEP to sell 15 percent of the capacity and the energy of the Rockport plant to Kentucky Power. The financial effect of this agreement was practically identical to the purchase by Kentucky Power of 15 percent of the plant. In essence, we felt that the unit power agreement was simply a tactic by AEP to use the FERC to require Kentucky Power to do something the Kentucky PSC had ordered it not to do. We refused to allow Kentucky Power to pass through to its customers the extra $23.3 million a year in costs from the imprudent unit power agreement and our litigation with AEP began. To us, the AEP's tactics seemed a dangerous example of arbitrarily jumping to a federal forum in order to overturn the legitimate decision of a state public service commission. That this maneuver was even possible highlights the grave uncertainties that exist in the interpretation of the Federal Power Act.

AEP argued that once the unit power agreement was filed with the FERC, the Narragansett doctrine[2] applied and the Kentucky PSC was bound to accept the wholesale rate set out in the agreement in spite of any doubts it might have about its reasonableness. We have replied that we are not questioning the reasonableness of the wholesale rate, but are challenging the prudence of the unit power agreement for Kentucky Power when it had available the much less expensive option of purchasing power from the pool. This argument is based on the prudency exception to the Narragansett doctrine stated in the case of Pike County Light & Power Co. v. Pennsylvania PUC.[3] Our argument has been bolstered by the FERC's explicit statement that the Kentucky PSC has the right to examine the prudence of the unit power agreement when compared with other options.

This brief summary cannot possibly convey the complexity and subtlety of the legal arguments. The upshot, however, is that the Kentucky PSC has thus far been successful in all forums. The decision of the U.S. District Court to abstain from involving itself in the case was upheld by the Sixth Circuit Court of Appeals.[4] This decision by the Sixth Circuit was recently labeled "a severe blow" by the AEP's rate counsel.[5] AEP has filed a petition for certiorari in the U.S. Supreme Court. The Franklin Circuit Court in Kentucky has found that the Kentucky PSC's disallowance of the unit power agreement was fully justified.[6] AEP has appealed this decision to the Kentucky Court of Appeals.

S. 1149

Part of the reason for the success of our legal efforts may be the transparency of AEP's attempt to overturn the lawful decisions of the Kentucky PSC through legal maneuvering. Our prospects for continued success have been greatly strengthened by the U.S. Supreme Court's recent decision in Nantahala Power and Light, et al v. Thornburg, et al.[7] While Nantahala represents the Supreme Court's first affirmative recognition of the Narragansett doctrine, it also represents the first acknowledgement of the Pike County exception. The Court assumed, without deciding, that a state commission was not bound to accept as reasonable a FERC-approved price for purchase of power if a quantity of lower-cost power was available. Yet given the uncertainties that have emerged since the Colton case[8] was decided more than 20 years ago, it may well be time for Congress to clarify the issues surrounding federal and state jurisdiction.

S. 1149 is a rather straightforward attempt to address some of the problems created by this jurisdictional confusion. It would at least partially repeal the Narragansett doctrine under certain circumstances. The language is somewhat vague as to what would be the ingredients of a state's "determination not to take into account all or part" of a federally approved rate. I would suggest adding language that explicitly codifies the prudency exception of the Pike County case as set forth in Nantahala.

The bill does not reestablish the "bright line" of the Colton case, but rather sets up concurrent state and federal jurisdiction. Perhaps, as the U.S. Supreme Court has indicated, the issues these days are too complex for the resurrection of a mechanical bright line test. S. 1149 raises two important issues that should play a part in any resolution of this jurisdictional controversy, whether by mechanical line-drawing or balancing of interests.

First, states ought to play a crucial role in determining the reasonableness and prudency of certain wholesale rates. State commissions are generally far more sophisticated than they were when the Colton case was decided two decades ago. With the construction and overbuilding problems of the past 15 years, states are frequently more skillful in full-blown prudency reviews than the FERC.

Secondly, multi-state holding companies require extremely careful attention by both federal and state regulators. These companies can achieve marvels of rational system planning, economies of scale, and efficient dispatching. But the fact that no one regulatory agency is completely responsible for them, can insulate them more than most utilities from the consequences of dramatic changes in economic conditions. AEP appears to be such a company. In the traditional sense, AEP has developed a highly efficient generation, transmission, and distribution system. But the traditional assumptions in which that development took place have changed markedly. Demand elasticities, a decline in manufacturing, and a steady restructuring of the national economy have substantially curbed AEP's load growth. If the entire AEP system were located in one state, it would have in all likelihood undergone much more vigorous oversight of its construction program and been subject to more pressure for least-cost planning, sophisticated forecasting, and conservation. Yet because of fragmented regulation and its ability to spread its costs among many jurisdictions, AEP has tended to continue building more and more large base-load power plants, hoping that it can make massive off-system sales until its customers grow into the capacity. Companies like AEP require much more sophistication by and cooperation among federal and state regulators.

Suggestions for Cooperation

There is an urgent need to use the provisions of the Federal Power Act to greatly strengthen federal-state cooperation. Section 209 of the Act, in particular, could be used to develop much more constructive relationships within the kind of joint board setting that has been successful at the Federal Communications Commission. Federal and state regulators could learn much from each other by serving on joint boards. If this kind of cooperation cannot be fostered under the existing section 209, then the section should be amended to make a joint board relationship mandatory.

Such enhanced cooperation is necessary to handle the special problems of wholesale transactions and multi-state holding companies. It is also vital to intelligently manage the fundamental structural changes that, it seems clear, are in store for the electric industry over the next two decades. These changes will be another chapter in the fundamental restructuring of this nation's basic industries. In fairly short order we have seen the divestiture of AT&T and an upheaval in the natural gas industry led by the FERC itself. (A joint board approach, by the way, could do much to smooth the way for changes in the gas industry.) Can the electric industry be far behind? To creatively guide the coming structural changes in the electric industry, to maximize their benefits and minimize their risks, greater cooperation among federal and state regulators through a joint board system is absolutely essential. The FERC, with prodding from Congress if necessary, should begin to establish such a system as quickly as possible.

That concludes my testimony.

FOOTNOTES

[1] Case No. 8271 - The Application Of Kentucky Power Company For A Certificate Of Public Convenience And Necessity, before the Public Service Commission of Kentucky. The application also sought authority to own a second 1,300 megawatt generating plant at the Rockport site. This plant is now under construction.

[2] *Narragansett Elec. Co. v. Burke*, 381 A.2d 1358 (R. I. 1977), *cert. denied*, 435 U. S. 972 (1978).

[3] *Pike County Light & Power Co. v. Pennsylvania Public Util. Comm'n.*, 465 A.2d 735 (Pa. Com. 1983).

[4] *American Electric Power Co., Inc., et al. v. Kentucky Public Service Commission, et al.*, No. 85-5129 (6th Cir., May 6, 1986).

[5] *Narragansett Update*, Kevin F. Duffy, rate counsel of American Electric Power Service Corporation, presented at Annual Meeting of Federal Energy Bar Association, May 22, 1986, page 12.

[6] *Kentucky Power Company v. Kentucky Public Service Commission, et al.*, No. 84-CI-1760 (Franklin Cir. Ct., Ky., March 24, 1986).

[7] *Nantahala Power and Light, et al v. Thornburg, et al*, 54 U.S. Law Week 4676, (June 16, 1986).

[8] *Federal Power Commission v. Southern California Edison Co.*, 376 U. S. 205, reh. denied, 377 U. S. 913 (1964).

Senator **Bumpers**. Rush, first of all, let me say that until yesterday I did not know that Kentucky was very much in the same boat that subsidiaries of Middle South were in, with maybe not as many dollars involved. Your statement is encouraging, in that you have won, as I understand it, at the district and circuit levels?

Mr. **Dozier**. That is correct, much to the dismay, of course, of American Electric Power System. They are determined to try to get that overturned in the U.S. Supreme Court and the Supreme Court of Kentucky.

Senator **Bumpers**. If you win this lawsuit, what effect would that have on the Narragansett decision? Does it erode it, overturn it?

Mr. **Dozier**. I think, from our point of view, what would happen would be a clear case, we would argue to the Supreme Court, of the Court having an opportunity to confirm the prudency exception to the Narragansett doctrine.

As you know, in Nantahala, the court, without deciding, seemed to assume that that existed but there was no definite finding that there is that prudency exception.

In our case, the FERC has not said that the State commission must do what it does not want to do. They have said that, although the rate under the unit power agreement is reasonable, the State does have the opportunity to look at the prudency of the purchase of power at that rate by Kentucky Power itself.

So in this case, the FERC seems to be admitting that there is a prudency exception, but the Supreme Court has never explicitly ruled on that exception. We would seek, if the Supreme Court takes the case up, to have the Court confirm that prudency exception. It is anybody's guess whether they will or will not when the issue is brought to them squarely.

Senator **Bumpers**. You know, we in the *Grand Gulf* case are on the way to the Supreme Court, too, I guess. Whoever loses at the circuit level is going to go to the Supreme Court, and I am hoping you win because I think it would have a positive effect on our case. Your point is well taken. Nobody questions whether or not the rate is reasonable if the purchase was prudent. That is not the issue in our case. It is in your case.

Mr. **Dozier**. That is right. The *Middle South* litigation goes directly to the reasonableness, and in that case there is some difference. Obviously, recognizing this prudency exception, we have made an effort to persuade the courts that it is reasonable for a State commission to say the purchase of power at a rate set by FERC is unreasonable. This is the least we can ask for, and S. 1149 goes further than that.

Senator **Bumpers**. You know, FERC never met an imprudent plant, either.

Mr. **Dozier**. Certainly one of the things I point out in my testimony is there needs to be more cooperation, at the very least, with FERC and the States. There is a joint board process that is provided for in section 209 of the Federal Power Act. We could actually be working together with FERC to look at prudency because the States are far advanced, I think, in prudency investigations, given our experience with excess capacity and other things in the last——

Senator BUMPERS. Do you know how many people FERC has to check prudency?

Mr. DOZIER. Very few.

Senator BUMPERS. They are not going to do an exhaustive prudency test because they do not have the personnel to do it.

Mr. DOZIER. In my conversations with people from FERC, they admit the States are much farther ahead on this issue. Nevertheless, despite requests from the National Association of Regulatory Utility Commissioners and others, FERC has not yet seen fit to invoke section 209 and convene a joint board.

I would certainly advocate, and I do in my testimony, that Congress mandate a joint board process if FERC refuses to at least take that step to bring the States into the process.

Senator BUMPERS. Senator Ford.

Senator FORD. Rush, just briefly give me the similarities of your *AEP* case and the *Grand Gulf* situation, and the distinctions between them.

Mr. DOZIER. The distinctions would be this was not an equalization case in which the FERC said, you know, we will put all the generating capacity in a pot and equalize it, depending on your member load ratio.

We did not get into the reasonableness of the rate that FERC decided was acceptable in the unit power agreement between Kentucky Power and the Rockport plant. We said OK, we are not going to contest that that is a reasonable rate at which Kentucky Power would buy this capacity from Rockport.

What we are going to contest is the fact that Kentucky Power can get that same energy much more cheaply from the American Electric Power System reserves. They are entitled to it through the pooling agreement. They have every legal right to it, so why should they be buying expensive power from Rockport when they can be buying much cheaper power from the AEP System.

Now, the Grand Gulf litigation, as I understand it, involves the equalization of capacity with Middle South, a number of nuclear plants, some of which are much cheaper than others, and it involves FERC's decision basically that certain States are going to have to buy a certain portion of the plant and pass those rates through.

So FERC decided that certain rates were reasonable, certain behavior was reasonable. The States, as I understand it, said no, that is not reasonable. I would assume they would say it was also not prudent for their utility. So in that sense, to the extent they would say it is not prudent to do what the FERC wants us to do, there would be some similarities.

To the extent that they say those rates are not reasonable, we, in our case, have not gone that far and have not found it necessary thus far and have been successful.

Senator FORD. Up to now you have been upheld in every court as it relates to your position.

Mr. DOZIER. Yes, sir.

Senator FORD. Did I understand you to say that your resources are being depleted in this process? Are we running up against, in Kentucky for instance, an organization that has much more money than a State as it relates to——

Mr. **Dozier**. Absolutely. In the petition for certiorari by the American Electric Power System, they have added a former Solicitor General of the United States to their two other law firms. You are looking at the resources of the Kentucky Public Service Commission, Richard Raff.

Senator **Ford**. You are about to wear him out.

Mr. **Dozier**. He has other things to do as well. Richard has done a magnificent job of singlehandedly taking on a whole battery of very high-priced attorneys from New York and everywhere else and winning in every forum. We certainly hope to do that, but I do reiterate that Richard is only human. We are certainly having a tough time as it goes along to continue dealing with the massive amounts of paper and the massive amounts of time.

Senator **Ford**. That leads me to think out loud. Are you being so overwhelmed with paperwork and additional lawyers and so forth that at some point you might not be able to carry on? Are they trying to beat you down that way?

Mr. **Dozier**. They are certainly persistent. I would not want to say they are going to be able to beat us down. We will continue to fight, but it does become a heavy burden as time goes along and the years go along to continue this kind of litigation, particularly when there are so many other issues that the commission has to deal with.

We have a staff of attorneys, I suppose, of five, four attorneys with one vacancy, and they have a lot to do. We have great confidence that we will continue to prevail. Nevertheless, it is a strain.

Senator **Bumpers**. Senator Ford, I remember the story about the judge who said to the defendant, stand up. The defendant stood up, and he called the case, the *United States* v. *Jones*. Does the defendant have anything to say? The defendant says, judge, "Them seems like pretty unfair odds to me." [Laughter.]

Senator **Ford**. I have no further questions.

Senator **Bumpers**. Senator Pryor.

Senator **Pryor**. One quick question. I know our distinguished guest has to go to the airport.

You have a very, very splendid reputation, I might say, throughout this country and your work in the field of utilities, but do you sense, and this can be a subjective observation, I guess, that FERC is generally, do you think, attempting to preempt the traditional and historical regulatory and utility setting powers that they have had in the past? Do you think that this is a general movement this way? If it is, why is it happening and how is it coming about?

Mr. **Dozier**. I certainly think that is a major concern on the part of regulators. Peter Bradford will address that on behalf of the National Association. I have talked to Peter. He is very concerned, and we are all very concerned.

Yes, there is preemption. Middle South is a case that, you know, took us all by surprise in the way that FERC came down. Why they are preempting, I am not sure. In part, there are tremendous pressures being generated because of the enormous amount of dollars involved and the fact that so many of these companies have huge amounts of reserves and they just cannot sell all the power that they can generate.

This puts pressure on their rates. This causes consumer uprisings. It causes the State public service commissions to get very upset. I do not think FERC was necessarily prepared for this kind of pressure, and because of that perhaps their judgment is not as seasoned as it might be if they had been, like the States have been for the last 10 or 15 years, dealing with these prudency issues.

They are new at this game. As Senator Bumpers said, they have devoted very few resources to look at prudency, and what you are finding is multistate holding companies continuing with the philosophy of the 1960's and early 1970's of just build, build, build and hope that the load growth will grow into it.

Those days are gone. The economy is changing. There are elasticities of demand, which simply means that you raise the price of electric power and people are going to find a way to use less of it. So no one at the Federal level is putting pressure on these kinds of organizations to say you have to look into least cost planning and conservation and revising construction plans and prudency and all that. At the same time FERC is under tremendous pressure, as we all are, and they are not used to it.

Senator PRYOR. Thank you.

Mr. DOZIER. One other thing that Mr. Raff points out, too, is they are much more insulated from the ratepayers themselves than we, at the State public service commissions, are. We are not just talking about consumers, necessarily. We are talking about industrial and economic development, industrial customers. We are representing everybody, and if your rates just skyrocket it kills the industrial development in your State, not just hurting residential customers by higher bills but hurting them in the long run by fewer jobs.

Senator BUMPERS. Rush, let me say that is a very eloquent and articulate statement that you have made, certainly the best we have had before this committee on this issue at any time.

One other point I might make, just for the record, and that is, do you realize when FERC said we are going to equalize all nuclear generating capacity on the Middle South system, you know what they did? FERC assumed and took ratemaking jurisdiction for 65 percent of Middle South in one feld swoop.

If they would have just dealt with Grand Gulf, they would have taken away maybe 25 percent, but by equalizing they put under FERC's jurisdiction 65 percent of the capacity of the MSU system and leave the Arkansas Public Service Commission with, well, just a small percentage of the 35 percent that remains. It is rather bold encroachment on State authority.

Rush, thank you very much for coming.

Mr. DOZIER. Thank you, Senator.

Senator BUMPERS. Governor Clinton.

Governor Clinton, thank you very much for coming to be with us today, and you may proceed.

STATEMENT OF HON. BILL CLINTON, GOVERNOR, STATE OF ARKANSAS, ACCOMPANIED BY DR. ROBERT E. JOHNSTON, CHAIRMAN, ARKANSAS PUBLIC SERVICE COMMISSION

Governor CLINTON. Thank you very much, Senator Bumpers. As you know, I have with me the chairman of our Public Service Commission, Dr. Robert Johnston, who may be able to amplify on any of the remarks that I might make.

First of all, let me say that I am very glad to be here today, and I would have gladly waited until midnight to have my turn at this microphone, as you and I and Senator Pryor have been waiting for 14 months for this day. I am here to testify not only on my own behalf and behalf of the people of Arkansas, but I want to emphasize this most strongly, on behalf of the National Governors Association.

In 1984, after the staff of FERC recommended against us and the administrative law judge made his determination, I introduced a resolution before the National Governors Association reflecting the position embodied in your bill. One hundred percent of the Governors voted for it, every Republican governor, every Democratic governor. So I think it is fair to say that your bill represents the views of the Governors of the 50 States without regard to party.

I would also like to say that, as you know, our Congressman, Tommy Robinson, has a similar bill in the House of Representatives addressing this problem. He was just here and had to leave and asked me to inform you that, thanks in part to your success in securing this hearing, he thinks we will be able to have a hearing on the House side within the near future.

I will not read my whole testimony, but as you know and as you and Senator Pryor have been kind enough to mention, my involvement with this case goes back to 1977, and it has consumed a fair amount of my public life.

In addition to my testimony, I have attached a chronology of the Grand Gulf events, as well as the excerpts of the Federal Court decisions which are so supportive of the authority of the Federal Energy Regulatory Commission in this area.

I would just like to begin by saying that the present state of the law is bad law, horrible public policy, and terribly unfair to all of the States which have been affected by it. I will never forget, if I live to be 100, the clear memory I have of the president of Middle South Utilities in January 1977 raising his right hand and taking oath and swearing under the authority of the laws of the State of Arkansas to tell the truth and promising us that we would not have to pay for Grand Gulf if we built all the powerplants he wanted us to build.

Since that time, we built four coal-fired generating plants in reliance on the promises of Middle South Utilities that if we became self-sufficient and had enough capacity we would not have to pay for Grand Gulf. I was very young and, I suppose, naive then. I believed that you could believe anybody's word if they gave it under oath and realized that they could perjure themselves if they did not tell the truth.

In 1980 when people who were working for my administration when I was Governor discovered in documents filed with the SEC that we might, after all, have to pay for 17 percent of Grand Gulf no matter what, whether we needed it or not, I went to the officials of Arkansas Power & Light Co. and reminded them of the commitment made with the president of Middle South Utilities, under oath. To be fair to them, they secured an agreement in 1980 which was later ratified a second time and filed with FERC, giving Arkansas Power & Light Co., and its customers a zero allocation for Grand Gulf.

Now, when FERC made its decision, when the staff recommended, when the administrative law judge supported the staff, and when FERC unanimously supported the administrative law judge, what they said to the people of Arkansas was not only are we stripping your public service commission of its authority, but you can never again believe anything anybody from Middle South Utilities tells you because we might decide to change it. You can never again believe a written document filed as what we thought up to that time was a legally enforceable contract. You can never again believe that. We are running the show, and it is all going to be post facto.

Ever since that began to happen to us, I think I know how people feel in countries such as those that are memorialized in novels like Animal Farm and 1984. You never know where you are. Power is total, arbitrary, and absolutely unconcerned with the interest of the ordinary citizens.

There probably is not much I can add to that, but I would like to say that there are two or three very clear lessons to be drawn from this case if we leave the law just like it is. I would like to just summarize them, if I might.

First of all, FERC, using as its rationale exclusive jurisdiction over power pooling under the Federal Power Act, is really trying to completely oust State commissions of all involvement of regulating the activities of parties to generation and transmission pool agreements.

That means that in our State and in all others similarly affected, they are trying to create a class of second-class ratepayers, because you have eloquently stated, and it will be supported by everybody who has reviewed the record, and it is supported by articles in Baron's, Forbes, Electric Utility Weekly and everybody else, that FERC rules for the utility and does not even consider the interests of the ratepayers.

So what we have here is a case where, in the case of Middle South, the poorest people in the United States of America, in States with higher than average unemployment rates, higher than average poverty rates, and now higher than average utility bills, are being told you are a second-class citizen. You cannot come to Washington and have your concerns heard. Nobody knows what you are living like out there in an environment, maybe living on $200 a month, like a lot of your constituents are. We do not care what happens to you. We are going to give the utility its money no matter how stupid the decision was, how arrogant it was, or what your State was promised. We do not have to honor any promises to your State.

It seems to me that it is a very dangerous thing for the Federal system to say that some utility ratepayers are more equal than others. I think we ought to do what we can to remedy that situation.

The second thing I would like to say is, as we have learned in the course of this whole episode, there is an enormous gap in the present scheme for regulating such special purpose holding companies like Middle South Energy. The SEC is supposed to look after the interests of the ratepayers along with the interests of the financial concerns, but they never do. The people who can look into it have dwindled from a high of 250 staff members a couple of decades ago down to 12 today.

FERC gets into the activity late, and basically, as you have pointed out, never does anything. So now what the utilities have is the best of all worlds: alleged regulation at the Federal level, which does nothing, preempting any attempts by the State to protect the ratepayers.

The ratepayers have the worst of all possible worlds when nobody can take up for them, and the people they depend upon to do it are, in effect, stripped of all capacity to do so.

The third lesson, it seems to me, and maybe the most important of all, is that ironically under an administration which came into office promising to get the Federal Government off our backs, promising to deregulate, promising to give more authority back to the States, the balance between the State and Federal Government in the area of setting electric rates has been utterly destroyed by the decisions of the Federal Energy Regulatory Commission in all the States affected.

Now, we have some hope, I suppose, that the courts could remedy this balance, but the results are mixed. I think you can make significant distinctions between what has happened to us here and the *Narragansett* doctrine, which is fairly well established. I think you can make distinctions between the recent decision of the Supreme Court in the *Nantahala* case and the case here.

To be fair, the Supreme Court did recently rule regarding a multi-State telephone company, which was attempting to force higher telephone rates by having recourse to the Federal Government to use the Federal Communications Commission's depreciation schedules to override State decisions, stating that Congress did not intend for the Federal Government to have that authority. If Congress had wanted the Federal Government to be able to set retail telephone rates, the Congress would have explicitly said so.

I can only hope that if you are unsuccessful in getting a legislative remedy, we will get that kind of a decision out of the Supreme Court, but based on the decisions of the eighth circuit and the Federal trial courts, I cannot be too hopeful. I was glad to hear the results of the sixth circuit in the previous testimony.

I think I can speak for every Governor. The people who come behind me may say, well, if you give the States the authority outlined in the Bumpers-Pryor bill, there will be no more pool power agreements anymore. That is not true. The NGA supports pool power agreements but only when it is in the interest of all the States involved, only when it is a voluntary situation, only when the State regulatory commissions have a chance to decide whether the interests of the ratepayers are being protected. So I think that you may find that this is a precondition of having legitimate good pool power arrangements.

The second thing I would like to say is we are in the period now, and we have been, really, for almost 10 years, when forward-thinking people know that the potential for conservation in electricity is absolutely enormous and still only dimly tapped in many areas.

Half the ratepayers in this country live in jurisdictions where they are actually rewarded financially by utilities for conserving.

Many utilities, including Pacific Gas and Electric, the country's biggest electric company, are lowering their rates now because of changed economic conditions and because they have been governed by rigorous, tough, but fair State regulatory commissions who understand how to balance the interest of the utilities as against the ratepayers.

Now you have the poorest States in the country in the absolute vicelike grip of the most insensitive Federal bureaucracy I have ever seen. So what are they looking for? Ten years of increased rates. Ten years of increased rates when we are trying to be competitive for new industry, we are trying to be able to give our people a decent standard of living, when we are looking all around us in the most prosperous places in the country and we think maybe we can lower our rates. We are looking forward to 10 years of federally imposed increased electric rates because they have stripped us of the power to protect our people.

I think you know, Senator Bumpers, that this issue is an open wound in the minds of the people of Arkansas, and it will not go away, and it will not close up because they know that we were done wrong. I think that the testimony that you will hear and the comments that you have already made indicate that this is certainly not a problem confined to the States in the Middle South system.

So I would just like to say one final thing. I think the people who are opposing this bill probably feel pretty comfortable that they have you beat. I mean, after all, it took us over a year to get a hearing, and I think a lot of people may think this is just a little exercise and after it is all over we have to make sure that the utilities get everything they need to continue to pay dividends and increase wages and go on with business as usual.

In my view, if that happens, I would have to tell every Governor of every State in the country that face new powerplant decisions such as the one we are already saddled with if you are in a multi-State holding company you ought to get out of it if you have to tear the whole system down all across the country. Do not let them do to you what has already been done to us.

I would have to tell every other Governor if somebody wants you to join together in making an agreement to jointly construct a powerplant that you may need a portion of, I would not do it because you cannot depend on your contract being upheld. FERC has contempt for you. They do not care what agreement you made. They do not care what promises you made. They do not care what commitments were made to you under oath. All they want to do is to make sure that the money keeps flowing into the coffers of the utility holding companies of this country.

So I think you may have a revolt among Republicans and Democrats alike at the State level, and the whole utility holding company system may be wrecked and we may face a decade of litigation over what the appropriate compensation is as these companies are broken up by State action. There is a limit to how much we should be asked to endure.

I want to say again how terribly grateful I am to you and Senator Pryor and to those who are supporting this legislation. I urge you not to give up on it.

I want to say one final thing to those who think that you have no chance to pass it. I notice that the Senator from New Jersey, who has been a friend of mine for a long time, came in and out during the pendency of this hearing. He told me once, and I laughed at him. He said, you know, every interest group in this country is against tax reform, but the only way they can stop it is to keep it from ever seeing the light of day because it is the right thing to do. If we can ever get a decent, fair hearing on it, it will sweep the country.

He turned out to be a lot smarter on that issue than I was, because I did not believe it. I would just encourage you and Senator Pryor because justice is on your side, the Governors of this country are on your side, and you have this issue seeing the light of day now. We want to do what we can to help you prevail.

[The prepared statement of Governor Clinton and a subsequent submittal from Dr. Johnston follow:]

PREPARED STATEMENT OF HON. BILL CLINTON, GOVERNOR OF ARKANSAS

THE LESSONS OF GRAND GULF
THE STATEMENT OF GOVERNOR BILL CLINTON

Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to speak to you today on behalf of the people of Arkansas and the National Governors' Association on the relationship between the Federal Energy Regulatory Commission and state public utility regulatory commissions and, more specifically, S. 1149, sponsored by Senator Bumpers and Senator Pryor of Arkansas. This bill marks the beginning of a desperately needed move toward restoration of the Congressionally-intended balance of federal and state jurisdiction in the area of electric utility regulation. As you know, this balance has been upset by recent decisions by the FERC and in the federal courts which have had the effect of nullifying state regulation, particularly over subsidiaries of public utility holding companies.

When I reviewed the membership of the full Committee on Energy and Natural Resources, I realized that nearly every Senator has been exposed in one way or another to the problems besetting electric utility companies which have overbuilt power plants during the past decade. As you know better than I, many of the problems presented by the completion or cancellation of plants such as Zimmer, Palo Verde, Colstrip, Seabrook, Wolf Creek and the ill-fated "Whoops" plants (WPPSS--Washington Public Power Supply System) have been dealt with by the men and women who serve on the public utility commissions and courts of your states. I am sure that you feel that your comissioners are doing the very best job they can to balance the interests of ratepayers and the interests of utility company investors as they confront these difficult problems.

What I want to tell you about today--the lessons of the Grand Gulf experience--is certain to be characterized by opponents of S. 1149 as a parochial concern of the people of Arkansas. I want you to know why that is not so and why you should view it as a profoundly disturbing harbinger and an instructive case study. This is true even though in some ways Grand Gulf is unique--an anomaly on the national scene. It is a two-unit facility, of which Unit 1 is now operating, which constitutes the sole asset of a generation company which is a wholly-owned subsidiary of Middle South Utilities, Inc., a public utility holding company permitted to exist under the Public Utility Holding Company Act of 1935. The owner of Grand Gulf is Middle South Energy, Inc. (MSE), which was created in 1974 to own and construct the Grand Gulf plant and which contracted to sell all of its power and energy to affiliated operating companies in the MSU System. This contract was filed with the FERC in 1982. In the contract, called the Unit Power Sales Agreement, the MSU operating companies other than Arkansas Power & Light Company agreed to purchase all of the power and energy from Grand Gulf. It is this agreement that the FERC in June 1985 revised to require AP&L to take and pay for 36 percent of the power, notwithstanding that: 1. AP&L had never been a signatory to an agreement filed with FERC for approval in which it had agreed to purchase _any_ Grand Gulf power; 2. the ruling left Arkansas with huge reserves of unneeded capacity; and 3. the state PSC had permitted AP&L to build generating facilities in Arkansas based on MSU and AP&L commitments that we would not have to pay for Grand Gulf if we did not need it.

Since you will find other discussions of the facts and current status of the Grand Gulf case, which is now pending on appeal to the District of Columbia Court of Appeals, in the written comments filed by other parties appearing before you today and in attachments submitted with my testimony, I will not belabor the specifics of how Grand Gulf came to be. Instead, I want to concentrate the remainder of my remarks on what I consider to be the principal lessons of Grand Gulf and how Congress should address the problems it exposes in our dual system of federal and state regulation of electric utilities.

LESSON NO. 1. _Using as its rationale its exclusive jurisdiction over power pooling under the Federal Power Act, the FERC is moving to oust state commissions from all involvement in regulating the activities of parties to generation and transmission pool agreements, thus creating a class of second-class ratepayers who are left unprotected owing to FERC's failure or inability to hold utilities responsible for imprudence, mistakes in forecasting, and overbuilding._ In order to bail out troubled (mostly nuclear) utilities, the FERC is increasingly acting beyond its statutory jurisdiction to craft "cost allocation plans", "production cost equalization" schemes, and pool-membership pre-emption rationales which fence state utility commissions out of the process of reviewing the balance of interests between ratepayers and investors. The result is that by exalting its role as "impartial arbiter" over "warring" states in pooling situations, the FERC has taken sides with utility holding companies, generating companies and utility shareholders and against the states, state commissions, and retail ratepayers. This is a perversion of FERC's proper role which, if not corrected by the courts or Congress, will lead to the best of all worlds for the protected companies: federally enforced pre-emption at the state level, with friendly treatment at the FERC which mandates rate relief from state agencies for decisions not approved by those agencies. It will lead to the worst of all worlds for the unprotected retail ratepayers, who will be the victim of equalization schemes which socialize the risk of failed power plant ventures by making all such ratepayers within a power pool pay for projects even if they are not needed, were never approved at the state or local level, and, I fear, even if they do not work or are cancelled or abandoned.

The ingenuity of the FERC in the past few years in rationalizing its decision to spread costs of a plant, such as the $3.6 billion Grand Gulf Unit 1, over ratepayers in four states without ever expressing a concern that shareholders of the utility which built and owns it should bear any of the risk or penalties of overbuilding is equalled only by the cleverness and nerve of the utility managers who devised corporate structures and a dummy cost pass-through entity like MSE, which can engage in creative financing and manage to circumvent state regulation of the very basic issue of need for power, while achieving more favorable cost recovery and rate treatment at the FERC.

Grand Gulf is the earliest and, to my knowledge, so far the only example of such a scheme in which an entire nuclear plant was placed into the rate base by the FERC, without any review whatsoever of the prudence of its construction, rather than by the state commissions; it is undeniable that the citizens of my state and the other MSU states who are having to pay for Grand Gulf have been relegated by FERC's callous actions to a type of second-class citizenship. This is especially apparent when one compares our ratepayers to those in other states where traditional decisions on rate base, need for power, and the economic impact of new plant construction have been and can still be made by state utility commissions. Perhaps Congress intended that poor states like Arkansas and Mississippi be treated in this fashion when it enacted the Federal Power Act and the Public Utility Holding Company Act, but I find it hard to believe.

In answer to those who may be thinking that Grand Gulf and MSE are simply an aberration and that it can't happen to them, take a look at the situation involving efforts by the American Electric Power system companies to equalize transmission costs. In a ruling last September (Docket No. ER84-348-002 et al.), the FERC ruled that the public utility commissions in West Virginia, Virginia, and Ohio are pre-empted from reviewing the prudence of various AEP companies operating in those states in entering into a transmission equalization agreement whereby the cost of the AEP Syestem's EHV transmission network would be allocated among the members of the AEP power pool on the basis of relative demand, instead of the geographic approach followed in the past. In the following abridged quotation from its order in that case, the FERC rationalizes its decision to pre-empt state commissions:

> Transmission and the allocation of the costs of the established AEP transmission network are integral parts of the operation of the AEP pool. Therefore, the prudence of being a party to the EHV transmission agreement cannot be considered separately from the prudence of being a party to the entire AEP pool relationship. A challenge to the membership in a public utility holding company power pool of a member of the holding company is a federal matter. (See Note 1)

In an accompanying footnote to that passage, the FERC elaborates on the reasons for excising the states from any role to play in regulating these issues:

> We note that the formation and dissolution of holding companies is regulated by the SEC. 15 U.S.C. Section 79a(c), 79e (1982 ed.). Under the Public Utility Holding Company Act (PUHCA), a holding company must operate on an integrated basis. 15 U.S.C. Section 79k(b) (1982 ed.). Therefore, the question of continued membership in a holding company power pool raises in the first instance the question of the composition of the holding company which is within the jurisdiction of the SEC.
>
> The broad scope and purpose of SEC review of holding companies is set forth in PUHCA, Section 1, 15 U.S.C. Section 79a, under the heading "Necessity for Control of Holding Companies." Section 1 of PUHCA sets forth the ultimate or fundamental objectives of the Act; namely, the protection of consumers of gas and electricity and the protection of investors in utilities. The abuses PUHCA seeks to correct, as well as the purposes it proposes to accomplish, would require the consideration of certain factors set forth in Section 1 of the Act. Those factors include: (1) the cost of gas and electricity for consumers; (2) economy of management and operation of operating companies; (3) economy in raising capital for and financial management of utilities; (4) protection of utility investments; (5) effectiveness of utility regulation; and (6) adequacy and efficiency of utility service. The review of these factors by the SEC in the course of its regulation pre-empts state review and determination of the prudence of the overall membership and operation of the holding company system. For example, such review would inevitably involve findings which overlap with those made by the SEC in the course of its regulation. (See Note 2)

While I certainly disagree with the FERC's interpretation of PUHCA, an act it does not administer, I cannot help observing that the actions of the SEC during the 12 years of the Grand Gulf debacle belie its supposed concern with all of the six factors listed except numbers (3) and (4), both of which have to do with protecting investors. I also fear that if the FERC operates under the assumption that the SEC is the federal agency that looks out for the interests of "consumers", then FERC may have an excuse to relax in its job of considering the conflicting interests of stockholders and ratepayers, particularly where holding companies are involved. We cannot tolerate this kind of buck passing or even the possibility of its existence, and so must be vigilant to amend the Federal Power Act and PUHCA if the agencies that administer them are not sure of their roles and responsibilities vis-a-vis the states.

LESSON NO. 2--As we have learned in the course of attempts to obtain regulation over the activities and investments of Middle South Energy, Inc., there is a substantial gap in the present scheme for regulating such special purpose holding company subsidiaries.

Entities like MSE are engaged in massive enterprises that affect ratepayers in a number of states. This size and the diversity of interests of effected utilities works to create practical and legal impediments to the effective exercise of any state jurisdiction. At the same time, the SEC, which under the PUHCA has legal authority to regulate transactions among holding company affiliates, does not exercise this authority to review the feasibility of investments in planned generating facilities. The FERC's jurisdiction over transmission and sales of electricity in interstate commerce does not come into play until a generating unit is either abandoned or within 120 days of operation. Then, as we have seen, the FERC exercises its jurisdiction to pursue the utility's recovery of its investment--not to constrain it. The result of this hiatus in regulation is that the ratemaking process threatens to become a means of achieving for utilities like MSE whatever the traffic will bear.

From the looks of things, and particularly in light of the judicial hostility to state regulation of electric utilities, it is obvious that some legislative work is necessary to revitalize federal regulation and reinstitute state regulation to its proper role. Legislative remedies are needed to restore an approach to regulation that recognizes the need to balance consumers' interests against those of utilities, and to subject plant investment to the searching inquiry that the 8th Circuit Court of Appeals has said states are constitutionally precluded from imposing. (See Note 3)

In searching for ways to close these regulatory gaps, I hope you will begin with a serious consideration of S. 1149. It puts the states back in the business of approving power plant construction before the costs of the plant can be passed on to the ratepayers.

LESSON NO. 3. My final point, and the most important lesson to be drawn from the Grand Gulf debacle, is that it is more important than ever to restore the historical balance between federal and state regulatory authorities in the establishment of retail electric rates. The reason is that what happened to us in Arkansas and the Middle South region can happen to you and the citizens of your home states. In August of 1984, I proposed a resolution which was unanimously adopted by the National Governors' Association, which placed all the nation's governors on record as supporting the historic right of the individual states--all of them, not just those who are not saddled with public utility holding companies--to determine whether or not to pass along to their ratepayers the cost of both in-state and out-of-state generating facilities, based on need, reasonableness of construction costs, and whether the utility has complied with state laws on plant financing or other relevant state statutes. I am very pleased that Senator Bumper's bill being considered here today would go a long way toward reaffirming the right of the states to make these determinations.

The governors recognize that it is often possible for utilities to improve local service and reduce costs by working cooperatively with utilities in other states or even other regions. NGA has strongly endorsed the notion of regional electric utility planning to ensure that these potential benefits are realized. The Association is also establishing a Task Force on Electric Utility Transmission Policy to ensure that the nation's transmission system is adequate to allow utilities to capture potential savings from regional coordination and development.

But the potential benefits -- in the form of lower utility rates -- from such coordination cannot be assured unless states have the opportunity to assure that utility capacity planning and investment decisions are made in the best interest of local ratepayers.

The Middle South case is fundamentally different from the Narragansett ruling. The latter established a principal that utilities should not have to undergo more than one determination of justness and reasonableness of rates in power sales. The case did not, however, refer to utility decisions to invest in a new plant or in a portion of a plant.

The Middle South case, on the other hand, involves a reassignment of cost responsibility for capacity investment, without an opportunity for review by state commissions. The decision set a precedence for FERC to re-assign capacity obligations within a holding company, shifting access to lesser cost and responsibility for higher cost capacity among the member utilities. This is fundamentally different than the system which has been in place, and with which state commissions have worked, in which each utility is responsible for the costs of its own plants. To the extent that there is an opportunity to trade power from systems with excess capacity to systems with deficient capacity, it is done at the margin. Each utility does not share a percentage of each plant equal to its portion of system demand. As such, the Middle South decision, constitutes a very basic transformation of federal regulatory authority over the capacity decisions of individual utilities.

This ruling establishes incentives for inefficient capacity development at a time when the efficient development of least cost capacity is an increasingly important component in minimizing rate increases.

First, the ruling creates uncertainty for individual utilities and states with regard to capacity planning. The prospect of having capacity obligations reassigned in the course of a multi-year construction project means that no state regulatory or planning agency will be able to predict the need for additional supplies. To the extent that the Middle South decision erodes the ability of states -- and even utilities -- to control or at least know the amount of capacity that will have to be absorbed in the future, this important planning function is eroded.

Second, the decision creates an incentive for overinvestment in capacity by offering utilities the possibility that the costs of investment in excess capacity will be borne by other utilities. Utilities with conservative investment strategies will likewise be punished by being required to bear the costs of excess investment decisions made by others.

Third, the decision creates a disincentive to invest in or promote conservation or cogeneration. Since these forms of power do not "count" as capacity in ratemaking, utilities which in good faith promote least cost, non-central power station supply options will find themselves paying double for their own efforts and for central station power built by others.

The effect of these factors -- reducing the reliability of capacity planning decisions, increasing the incentive to overbuild, and decreasing the benefits to ratepayers of promoting conservation and least cost energy acquisition -- may well negate the potential gains which can be derived from interstate coordination and result in general rate increases for all consumers.

These are the initial effects of the Middle South decision. The decision is likely to trigger, in turn, an unwillingness on the part of states to permit utilities to enter into cooperative arrrangements in the first place, as a means of retaining control over the cost of utility investment decisions, with the result that whatever benefits may be obtained from increased power transactions will not be realized. In addition, states may be tempted to substitute allowed rates of return as a tool for approving or disapproving of out-of-state investment decisions, a tactic which is simply not as efficient.

S.1149 would overcome some of these drawbacks by placing states, once again, at the front of utility investment decisions. Because the bill only allows state commissions to disapprove rate passthroughs for unapproved capacity projects, utilities are given a strong incentive to work with states from the beginning in planning and developing sufficient and least cost capacity for local ratepayers.

NGA policy strongly recognizes both the importance of promoting least-cost regional electricity markets and the continuing state role of overseeing utility service to local consumers. If state regulatory authorities are not permitted to consider utility investment decisions, or may only address a portion of these decisions, protection of local ratepayers -- the primary function of state regulation of the industry -- is lost. Instead, local ratepayers are forced to take the financial risk associated with ventures by their utilities into capital and supply purchases possibly unassociated with local utility supply requirements. It creates an expensive incentive for utilities to overcapitalize, an incentive states can ill affort while absorbing the high costs of prudent and needed investments. We believe S.1149 will go a long way in restoring some of this balance.

I noted with great interest the language used by the United States Supreme Court in its excellent telephone depreciation decision of May 27th. In that decision, the Court found that Congress had established "a system of dual state and federal regulation over telephone rates" and had placed "express jurisdictional limitations" on the power of the Federal Communications Commission, thus "fencing off" the FCC from reaching or regulating intrastate matters. In that case, the Supreme Court found that "an agency literally has no power to act, let alone pre-empt the validly enacted legislation of a sovereign state, unless and until Congress confers power upon it. (See Note 4)

While the Supreme Court's recent decision in Nantahala clearly declares that a state "must . . . give effect to Congress's desire to give FERC plenary authority over interstate wholesale rates, and to ensure that the states do not interfere with this authority", (See Note 5) it nowhere finds that FERC has the authority to compel purchases of power at wholesale or to pre-empt the right of the states to examine the prudence of such purchases. These questions are still very much at issue in the Grand Gulf appeals now pending. Because recent FERC decisions have rendered murky and uncertain the state of the law governing electric utility regulation by the states, particularly where holding companies and power pools are involved, it is time for Congress to drive home to the FERC, and to the federal courts if that should become necessary, that the traditional, indispensable, and more efficiently performed role of the states in regulating need for power, utility securities issuances, the prudence of purchasing power, and least-cost energy planning must be preserved and reaffirmed for all of the states with respect to all types of electric utilities. We simply must tell FERC: "We cannot afford to have two classes of ratepayers in this country: those who are protected by state regulators from the abuses of utility management and overbuilding and those who are not."

In closing, let me say that I am well aware that there are likely to be other appropaches that will be recommended, perhaps including amendments to S. 1149 or other bills amending the Federal Power Act or the Public

Utility Holding Company Act. I urge you not to stop with S. 1149, but to do everything within your power to root out the problems that need to be addressed and to reverse the aggrandizement of power that is being engaged in by the FERC and that is harming your constituents more with every passing day. Here is a real chance to get the federal government off our backs and allow President Reagan's often-espoused goal of "new federalism" to really work.

NOTES

1 Order on Motions to Limit Issues or For Clarification and Motion to Dismiss and Denying Motion to Reopen Record, Sept. 13, 1985, Docket ER84-348, p. 10. (Emphasis added.)

2 Id. at fn. 4. (Emphasis added.)

3 Middle South Energy, Inc. v. Arkansas Public Service Commission, 772 F.2d 404, 416-17 (8th Cir. 1985).

4 *Louisiana Public Service Commission v. Federal Communications Commission,* No. 84-871, May 27, 1986, Slip opinion at 18.

5 Nantahala Power and Light Co. v. Thornburg, No. 84-568, June 17, 1986, Slip opinion at 13.

ATTACHMENT A

Grand Gulf Chronology

In 1973, Middle South Energy, Inc. got approval from the federal government and the Mississippi Public Service Commission to build Grand Gulf.

In 1974, the financing agreements were developed obligating the operating companies including AP&L to make advance payments on Grand Gulf to the bankers by certain dates if the plant was not operating and selling electricity. No one in Arkansas was made aware of the obligations of AP&L under this agreement which was filed only with the Securities and Exchange Commission and was never published in the Federal Register.

In January 1977, MSU President Floyd Lewis promised under oath at a PSC hearing that Arkansas ratepayers would not have to pay for Grand Gulf if we did not need it.

In 1980, employees of our Energy Department discovered in documents filed with the SEC that AP&L would have to pay for a portion of Grand Gulf whether the company and its ratepayers needed it or not. Then Attorney General Bill Clinton urged AP&L President Maulden and other AP&L officials to make good Floyd Lewis' promise that we would not have to pay for Grand Gulf since we had a large power plant surplus. Evidence now shows that all MSU companies had agreed in

January 1980 that AP&L did not need and could not economically use Grand Gulf energy and that the other companies could use it and were willing to take AP&L's share.

In July 1980, the other MSU companies signed a Memorandum of Understanding allocating none of Grand Gulf to AP&L.

In July 1981, seven months after Governor Bill Clinton left office, this Agreement to release AP&L from its obligation for Grand Gulf was formalized as the Reallocation Agreement. Part of that Agreement was to "hold AP&L harmless" from any other obligation for Grand Gulf the company might have under the second amendment to the Availability Agreement which did allot 17.1% of the financing costs of Grand Gulf to AP&L. In other words, the banks would not agree to release AP&L's promise to guarantee that loans on the project would be paid, but the other companies did agree to reimburse AP&L for any out-of-pocket Grand Gulf costs it might be required to pay under the financial agreements.

In June 1982, in the Unit Power Sales Agreement, the other MSU companies again agreed that they would buy all the power from Grand Gulf and that AP&L should buy none of it.

In 1983, the representatives of ratepayers in Louisiana objected to a zero allocation for AP&L, arguing that MSU was really one integrated system, not separate operating companies, and that all should share in the costs of the MSU system's power plants. The staff of FERC agreed.

In 1984, the Administrative Law Judge of FERC agreed with the FERC staff and recommended a 36% share of Grand Gulf for AP&L.

In 1984, the National Governors' Association unanimously adopted Governor Clinton's resolution asking the FERC to leave electric rate setting to the control of the states.

In the spring of 1984, Arkansans sent hundreds of thousands of post cards to the President asking him to have his Energy Secretary advocate the "states rights" position on this issue.

In 1984, the federal Energy Secretary, instead, went to Mississippi and asked the PSC there to go on with Grand Gulf II.

In June 1985, the full FERC adopted the Judge's allocation of 36% of Grand Gulf to AP&L.

AP&L then embarked on a two-pronged course. First, AP&L cooperated with the state in appealing the FERC decision. But second, AP&L sued the PSC in federal court asking that the PSC be prohibited from ruling on AP&L'S retail rate case on Grand Gulf issues because they had conspired with Governor Clinton to deny all rate relief for Grand Gulf.

Meanwhile, the 8th Circuit Court of Appeals upheld Judge Woods' finding that our PSC could not even examine the contracts by which AP&L and other MSU companies had entered into the Grand Gulf agreement in 1973. The court said the PSC could do nothing to keep high priced Grand Gulf electricity out of Arkansas.

Then Judge Waters said AP&L had a right to get enough of a rate increase to pay its Grand Gulf bills and return a profit for its shareholders.

Then and only then did the Attorney General and the other ratepayer representatives agree to a settlement which the PSC accepted as the least damaging alternative to Arkansas.

EXCERPTS FROM: ATTACHMENT B

M.S.E. v. P.S.C.
and
Mississippi Industries v. FERC

The decision by the United States Court of Appeals for the Eighth Circuit in Middle South Energy, Inc. and Arkansas Power and Light Company vs. Arkansas Public Service Commission; Judge Frank Waters' memorandum opinion of August 28 in Arkansas Power and Light Company vs. Arkansas Public Service Commission and Judge Waters discussion of the Eighth Circuit ruling in a hearing before his court on August 23 strongly suggest that in the Eighth Circuit, Middle South Utilities and Arkansas Power and Light will be allowed to recover the full costs of 36% of the Grand Gulf nuclear generating plant from the ratepayers of AP&L if the federal courts are afforded the opportunity to rule on AP&L's rate request which was pending before the Arkansas Public Service Commission.

The Eighth Circuit Court of Appeals order affirmed United States District Judge Henry Woods' ruling that the Arkansas Public Service Commission could not even conduct an inquiry into the various transactions between Middle South Utilities and its subsidiaries which pertain to the construction and financing of the Grand Gulf plant. The Eighth Circuit Court of Appeals said that:

> "Essentially, the APSC is trying to secure for Arkansas the zero allocation embodied in the UPSA. Such a result would be contrary to the 36% allocation recently approved by the FERC in

> regulating the wholesale aspects of the Grand Gulf project."

The Court of Appeals further concluded that the Arkansas Public Service Commission's actions were motivated by the Commission's desire to protect the economic interests of the State of Arkansas.

> "The APSC seeks to cancel the Grand Gulf agreements ostensibly because they have not received the necessary state regulatory approval. Its apparent concern, which has been made abundantly plain in its orders and its arguments before the FEC and the FERC, however, is the economic impact on Arkansas citizens caused by AP&L's participation in Grand Gulf."

In holding that such action would violate the Commerce Clause of the United States Constitution, the Eighth Circuit of Appeals cited the United States Supreme Court decision in *New England Power Company vs. New Hampshire* in which the New Hampshire Public Utilities Commission had sought to restrict the export of hydroelectric power produced within that state. The Court said:

> In *New England Power,* New Hampshire sought to contain within the state the benefits of low cost

> power. Arkansas, conversely, seeks to close its borders to high cost electricity.
>
> The effect of both actions is the same: a preference for citizens in the regulating jurisdiction gained at the expense of out of state customers. Nor can it be doubted that the APSC's action would constitute a direct and substantial burder on interstate commerce. The integrated nature of MSU and MSE, particularly in the Grand Gulf project, represents commerce that is interstate in a most basic form. Thus, this case is controlled by New England Power, and the APSC must be prohibited from voiding AP&L's role in the Grand Gulf project.

In summarizing its ruling, the Court said:

> "Here, the mere assertion of jurisdiction by the APSC had a negative impact on MSE's ability to obtain investors and complete its project, thus similarly interfering with the exclusive federal scheme for governing interstate power transmission and sales.

In discussing the Eighth Circuit's decision during a hearing before the Federal District Court for the Eastern District of

Arkansas on August 23, Judge Waters said:

> "What the Eighth Circuit said in that case was that the very act that the PSC was trying to engage in -- in other words, avoiding these contracts that FERC had ordered, or at least I think they said they ordered them, is in violation of federal law in and of itself.

In his memorandum opinion of August 28, Judge Waters concluded as follows:

> "In order for rates to be confiscatory, it is not necessary that stockholders receive no return and that the utility immediately default on its debts. If the rates ultimately and foreseeably produce such a result, the rates are impermissibly confiscatory. The rates must provide AP&L with a fair return on its invested capital...."
>
> "Thus, the only final position which the APSC may adopt which is consistent with its lawful duties is that AP&L is entitled to a fair return on its invested capital in an amount that would not constitute an overcharge to its consumers and the public."

ATTACHMENT C

Invited Testimony

by

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on

FEDERAL VS. STATE REGULATORY STANDARDS FOR ALLOCATING POWER PLANT CONSTRUCTION COSTS

to the

U.S. House of Representatives
Subcommittee on Energy Conservation & Power
Washington, DC

March 20, 1986

SUMMARY

The widening gap between state and federal treatment of power plant construction costs, along with a blurring of jurisdictional boundaries, creates a new potential for electric utilities to circumvent state regulation--with potentially catastrophic results.

Utility over-investment in power plant construction over the last decade has resulted in $40 billion a year in carrying charges for abandoned plants, excess generating capacity and over-budget nuclear power plants.

Regulators allocate plant costs between ratepayers and shareholders according to whether the investments were prudent, used and useful, or economical. The prudence standard only looks at whether decisions are reasonable at the time they were made. Utility investments should also be assessed on the basis of whether they prove to be used and useful and economical to ratepayers.

It is essential to allocate the costs of abandoned plants, excess capacity and uneconomical investments to utility investors in order for business risks to be internalized. Only then will utilities make the most economically efficient decisions.

Utility investors are already well-compensated for assuming these risks, and are responsible for oversight of utility management. Sharing business risks with the public would only be appropriate if decision-making is shared as well.

The Federal Energy Regulatory Commission (FERC) is increasingly diverging from the practices of most state commissions by allocating greater responsibility for cancelled plants, excess capacity and excess costs to ratepayers. Moreover, it is claiming pre-emptive authority over state commissions in a number of cases involving holding companies and power pools.

FERC has exclusive authority, as defined in the Narragansett Doctrine, to review the reasonable of wholesale rates of power producers. State regulators should and still do maintain authority--according to a number of court decisions and past rulings of FERC itself--to review the prudence of the wholesale power purchaser.

Utilities are moving to exploit FERC's generous ratemaking standards and claims to pre-emptive authority by establishing separate generating subsidiaries for exclusively wholesale power distribution. If utilities are thus allowed to shift the risks of new construction entirely to ratepayers, they are certain to engage in another round of costly over-investment.

Legislation to affirm state authority over the prudence power purchases, and requiring FERC to follow ratemaking standards more closely matching those of the states should be strongly considered.

Thank you Mr. Chairman, and members of the House Energy Conservation & Power Subcommittee. My name is Alan Nogee, and I have been a Utility Analyst with the Environmental Action Foundation for over three years.

Environmental Action Foundation (EAF) has been providing technical and organizing assistance to a network of hundreds of citizen groups and government officials working on electric utility issues for more than thirteen years. The Foundation also works closely with its sister organization, Environmental Action, which represents its members on energy and environmental issues in Washington.

My duties with the Foundation include research, writing and providing technical assistance to EAF's energy network. My 1984 study, Rate Shock: Confronting the Cost of Nuclear Power, examined the plant-by-plant and national cost to ratepayers of the 49 nuclear plants still under construction at that time. I track and write about regulatory treatment of plant construction and cancellation expenditures, and other electric utility issues, regularly in EAF's newsjournal, Power Line.

I am grateful for this opportunity to discuss the regulatory treatment of power plant construction costs. We are most concerned that a widening gap between state and federal application of regulatory standards, along with a blurring of the boundaries between state and federal jurisdiction, has created an incentive and an opportunity for electric utilities to circumvent traditional state regulatory controls--with potentially catastrophic results.

Utilities are already moving to take advantage of this opportunity. They are shifting business risks away from shareholders, who voluntarily assume them in exchange for the opportunity to earn returns, onto the ratepaying public. This transfer of risk to captive consumers has serious near-term economic consequences for ratepayers in several regions of the country. Moreover, it strengthens the already perverse financial incentives that have burdened consumers and utilities across the country with expensive excess generating capacity, cost overruns and abandoned plants. If not corrected, it will virtually assure that utilities will repeat the same costly mistakes again.

THE PROBLEM: OVER-INVESTMENT IN NEW POWER PLANTS

Utility regulators across the United States are faced today with the unenviable task of allocating the cost of failed utility construction projects between ratepayers and investors. Those failures are generally of three types:

1) Cancelled plants. More than 100 nuclear plants have been cancelled in different stages of planning or construction. The total sunk costs of these plants is approximately $18 billion.[1] Table 1 identifies the locations of the largest nuclear plant cancellations, and their impact on ratepayers. In addition, at least 15 coal plants have also been cancelled, although sunk costs for all except one were less than $100 million.

2) Excess generating capacity. Despite those cancellations, failure to accurately forecast demand growth has left many utilities with excess capacity. While most analysts agree that a 15 to 20 percent reserve margin above peak demand is needed to meet unexpected weather conditions or plant outages, the overall U.S. reserve margin was greater than 34 percent in 1984 and 1985.[2] We conservatively estimate that current excess capacity costs ratepayers more than $13 billion a year.[3]

3) Rate shock. The failure of utilities to control cost overruns or to implement least-cost methods of meeting needs for electric services, is leading to large rate increases as many new nuclear and coal plants are completed. The total annual increase in rates for the investor-owned

utilities with nuclear plants still under construction in 1984 would exceed $25 billion, if passed on to ratepayers in full.[4] Table 2 lists those utilities that have already received or applied for rate hikes for new power plants in the last two years.

These failures collectively cost over $40 billion a year. To put that number in perspective, consider that the total federal budget for low-income energy assistance is only $2 billion a year; that the food stamp program costs $12 billion annually; or that the entire MX-missile system is projected to cost about $30 billion over a number of years.

In many regions, these costs may have serious detrimental effects on local economies. For individual ratepayers--whether residential, commercial or industrial--higher utility bills mean lost income and purchasing opportunities, foregone investments and increasing pressure on industry to relocate to more favorable sites in other states or overseas.

Table 3 indicates estimates of the economic and employment impact of rate hikes requested for new power plants presented in various state commission proceedings. A number of areas are already experiencing this impact. In Arkansas, for example, the rate increase to pay for the Grand Gulf plant is widely considered the last straw that forced Reynolds Metals to close its operations in that state. Reynolds is the state's largest electric consumer and one of its largest employers.

REGULATORY STANDARDS FOR ALLOCATING PLANT CONSTRUCTION COSTS

Historically, regulators have relied on variations of three major standards in assessing how to charge ratepayers for utility investment in power plants. These standards--prudence, used and useful, and efficiency--are means to achieving an end result which balances the interests of ratepayers to be charged "just and reasonable" rates, with the interests of investors to receive a "reasonable" return on investment.

Prudence. The prudence standard, as generally interpreted, requires that a recoverable expense must have been reasonable at the time it was made, based on what was known or should have been known at the time, without hindsight.[5]

The conventional prudence test only evaluates decisions, and the decision-making process. It is unconcerned with the results of those decisions. If a decision to build a power plant is deemed reasonable at the time it was made, based on the best forecasts available at that time, the decision is presumed to have been prudent. Changed circumstances, beyond a company's ability to anticipate or control, could result in plant abandonment, excess capacity, or an economic nightmare, but money spent on it would still be fully recoverable.

Prudence evaluations may also focus on whether particular costs should be disallowed because a utility failed to use appropriate management controls, and on whether particular decisions should have been re-evaluated, based on new evidence that became available.

The burden of proving imprudence is generally on intervenors, and prudence audits for new plants may cost millions of dollars. For these reasons, as well as the fact that it is a decision-oriented instead of results-oriented test, prudence is the weakest standard for evaluating rate base additions.

Some states have also modified or are considering changing the conventional definition of prudence. We will return to that subject later.

Used and useful. This standard holds that a utility investment must turn out to be actually "used and useful" in order to be included in a utility's rate base. It is therefore concerned with the results of decisions, and more closely approximates how returns are earned in competitive markets.[6]

Regulatory bodies and courts, however, have frequently disagreed about the definition of the principle. Some commissions, for example, have held that plant construction work in progress (CWIP) is not used and useful and cannot be included in rates until it is actually generating electricity for commercial use. Others have held that ongoing investment in plant under construction is "useful" to current ratepayers because it provides "assurance" of adequate future capacity.

Cost-benefit A cost-benefit test requires that utility expenses be cost-effective, or economically efficient, to be charged to ratepayers. A new plant that may not be necessary to provide generating capacity, but that lowers rates by displacing more expensive fuels, may pass a cost-benefit test, for example. It is sometimes seen as a subset of the used and useful test, in requiring that an investment be economically useful, as opposed to just being operationally useful, to be included in rate base.

EVALUATION OF ALTERNATIVE STANDARDS

The choice of rate base standards and how to apply them rests fundamentally on decisions about how the risks of power plant construction should be allocated between utility ratepayers and utility investors.

Any investment decision, which must necessarily be based on assumptions about the future, carries risks that those assumptions will prove to be wrong. In a competitive market, investors assume those risks. A firm that makes decisions based on poorer assumptions than those used by competitors will earn a lower return- or even no return at all--regardless of how "reasonable" those assumptions may have appeared at the time.

In our view, and that of many regulators,[6] the purpose of regulation is to simulate the effects of competitive markets on firms that are deemed natural monopolies, and therefore lack competitors. On a retail distribution level at least, electric utilities are still protected monopolies, granted franchises of public convenience which virtually guarantee access to a near universal market for an essential service.

Thanks to the Public Utility Regulatory Policy Act (PURPA) of 1978, competition in generation is beginning to emerge. This may well pave the way for experiments in the deregulation of generation. For now, however, regulators must act to protect captive ratepayers from monopoly pricing that exceeds what a firm operating in a competitive market would charge.

In our view, effective regulation would require utility investments to pass *all three* of the forementioned tests to be recovered from ratepayers. As the sole provider of an essential public service, utility investment decisions must certainly be required to be reasonable, based on circumstances at the time they are made. Utilities should be required to employ state-of-the-art forecasting techniques[8] and management controls over costs.

Utility investments should also be both used and useful and of economic benefit to ratepayers. Application of a *used and economically useful* standard, where utility investors assume the risk of circumstances not successfully forecasted, simply requires utilities to submit to the same discipline and incentives experienced by firms operating in the marketplace. *Strictly interpreted, this test would prohibit any charges to ratepayers for abandoned plants, excess generating capacity, and new capacity that is more expensive than the least-cost options available to the utility.*

REGULATION AND RISK

Utilities generally raise three arguments against their assuming investment risk. First, they hold that forcing investors to assume risk will lead them to demand higher rates of return. In the end, consumers will pay in any case. Second, they argue that the "obligation to serve" requires them to make investments in new plant where unregulated firms might decide that the risk of the investment proving uneconomical would be too high. Third, utilities argue, firms in a competitive marketplace have the opportunity to earn unlimited returns when they make successful investments. Regulated firms, however, have ceilings placed on their returns. Therefore, they should also have floors below which returns should not be allowed to fall.

The argument that requiring utilities to bear more risk requires higher returns is, in part, correct. The higher future risks appear to be to investors, the higher current return they will require to compensate them for the possibility of failure in the future. All other things being equal, the cost of new plant construction will be higher.

In fact, the cost of new plants will be higher by exactly the amount that the marketplace perceives to be necessary to internalize the risks of failure. Only when the cost of construction accurately reflects its risks will utilities make the most economically efficient decisions.

Indeed, the apparent belief of utility managers that regulation would protect them from the risks of failure was certainly a major factor in encouraging utilities to overbuild. (Tax subsidies were certainly another.[9]) Even a recent study published by the Electric Power Research Institute, which largely seeks to absolve utilities of blame for overforecasting demand in throughout the 1970s, concedes:

"Senior utility executives probably judged the risk of not having

> enough generating capacity to be relatively great, perhaps recalling the experience of the Northeast Blackout. _In the early 1970s, a future penalty for overbuilding seemed small and the possibility of paying that penalty remote._"[10]
>
> (emphasis added)

If there is a single lesson to be learned from common sense, economic theory and the traumatic experience of utility overbuilding during the last decade, it must certainly be this: _those who make decisions should bear the risks associated with them._

With investor-owned utilities (IOUs), as with other businesses, utility managers are directly accountable to a board of directors elected by common shareholders. With IOUs, as with other businesses, shareholders are paid a premium for the assumption of that risk. If shareholders are not to be assigned business risk, why should they earn higher returns than bondholders, who are not assumed to be exposed to the same level of risk?

Current evidence shows that electric utility shareholders, in fact, are already being well compensated for assuming risks. Over the last five years, the total stockholder return for utilities, including yield plus stock appreciation, has been 22.9 percent per year, compared to only 13.6 percent for the Standard & Poor's overall industrial index.[11] Over the last ten years, during which we have heard so much about the utilities "poor" financial condition, the total return to utility shareholders was 14.4 percent, compared to 13.3 percent for overall industrial stocks.[12]

Utility shareholders are also very conscious of the risks they assume, as evidenced by the tremendous stratification in recent years of returns demanded of utilities with large nuclear construction programs, versus those without them.[13] In general, the market has already discounted utilities with troubled construction projects to reflect probable disallowances of cost recovery. When the Missouri Public Service Commission recently disallowed 16 percent of Callaway nuclear plant costs as imprudently incurred, for example, Union Electric's stock price immediately climbed to a 52-week high, reflecting investors expectations of an even more severe penalty.[14] Wall Street analysts are also now beginning to routinely value utilities based on their market-worth.[15]

Utility investors, therefore, are already being compensated for assuming the risks of construction, and are not likely to drive rates of return much higher, certainly not higher than they already are for major construction projects. The question is: having already been compensated as if they assumed the risks of their investments, will they then escape responsibility for absorbing losses when projects turn out to be failures?

What of the utilities' second argument, that obligation to serve justifies insulating utilities from risk? Utilities, by their nature as regulated monopolies, do have a legal obligation to meet the needs for electric service of their customers. But historically, the choice of how to meet those needs, as well as the assessment of what those needs were, has been left entirely up to the utility. In those states that have a certificate of need procedure, very few required extensive examination of alternatives, or required re-examinations during changing conditions. Even today, only eight states have comprehensive least-cost planning processes.[16]

Assuming, arguendo, that a utility must make some investment to meet prudently assessed future needs, it may well be unfair to penalize it simply because such investment might raise costs above current levels. But why should the company be further absolved of business risk for choosing investments more expensive than those that would have met those needs at the least cost?

Application of a used and economically useful standard would have regulators examine what the least-cost alternatives to the plant in question would have been--including investments in energy efficiency, alternative plant construction, or purchases of power from cogenerators, small power producers or other utilities. Commissions would then disallow investments above the least-cost level. The utility is thus not required to bear risks associated with the service requirement, but only with its own choices of how to meet that requirement.

Third, what of the "ceiling" that regulation places on a utility's earnings? As utilities frequently point out, there are, in fact, no real ceilings or guaranteed returns on a year to year basis. Regulators set a rate calculated to achieve a target rate of return based on a test year of either historical or future projected expenses. A utility's efficiency, as well as external forces, will then determine whether the allowed return is achieved or even exceeded. Last year, 35 utilities exceeded their allowed rates of return, and most of them will be able to retain the excess profits.[17]

In practice, of course, the process of regulation will tend to limit excessive profits and losses. As long as utilities remain predominantly monopoly enterprises, with exclusive franchises, they are still immune to many of the risks that businesses in competitive markets face. As long as consumers have only one source of electricity, it is necessary to protect them from monopoly pricing.

It should be noted that the above formulations do allow utilities many options for risk reduction and risk-sharing. The industry itself--at least in part--has finally begun to accept that investment in small-scale projects with shorter lead times, as well as demand-side alternatives such as efficiency improvements and load management, reduces risk exposure.[18]

Risk can also be reduced by the rejection of cost-plus and take-or-pay contracts from vendors. Only now, after cost overruns as much as 10-20 times the original cost and cost caps imposed by regulators, are utilities insisting on--and getting--fixed-price contracts.

In addition, a utility that wants to share financial risks with the public should share a congruous level of decision-making. Some utilities are even beginning to propose public review of planning decisions. Too often, however, this offer is made in exchange for a guaranteed return on investment.

Let us assume that a utility investment proposal undergoes a thorough public review. (By thorough, we imply the inclusion of adequately funded intervenors.) Such a process would help ensure that decisions were prudent. An appropriate level of risk-sharing might then be the return of investment, with no return on investment. Both shareholders and the public would assume losses from an investment that turned out to be uneconomic for reasons that were not foreseen.

A utility that wanted to share risk still further could do so by increasing the public's equity in the company or project. An interesting proposal by Professor Warren Samuels of Michigan State University published in Public Utilities Fortnightly about a year ago promoted one mechanism for trading public risk-assumption for public equity shares.[19]

Complete risk-sharing would be appropriate with a publicly-owned utility with democratic decision-making. Public utilities have no shareholders to put at risk, and do not have to pay premium returns. In this context, it is not necessary to make absolute judgments about the benefits of public vs. privately-owned power companies. The nation as a whole may well be best served by the widest variety of risk- and decision-sharing mechanisms. What is crucial is that in each case the levels be congruent.

STATE VS. FEDERAL APPLICATION OF RATE BASE STANDARDS

In theory, at least, the Federal Energy Regulatory Commission (FERC) and state utility commissions follow essentially the same legal standards for valuation of investments. In practice, there is a growing gap between how those standards are being applied.

Cancelled plants. In plant abandonment cases, most states and FERC have followed the practice of disallowing a return on sunk costs, based on the used and useful principle, but allowing recovery of prudently incurred costs through amortization over a period of years.

> "Ratepayers are required to pay a return on only those investments in properties that are used and useful in public service."[20]

In general, however, the FERC has allowed amortization periods of five to ten years, while state commissions have allowed amortization over ten years or more. In the case of the Tyrone cancellation, for example, FERC allowed amortization of five to ten years, while state commissions in Minnesota, North Dakota and South Dakota argued that the plant costs should be recovered over 30 years.[21] Longer periods of amortization shift more responsibility to shareholders, as they are denied the return and therefore the time value of their money for a greater time.[22]

Several state commissions and/or courts--in Ohio, New Hampshire, Oregon and most recently Indiana--have held that the used and useful standard bars any return of as well as a return on abandoned plant costs. In some cases, however, utilities have been able to partially circumvent this limitation through higher rates of return or "emergency" rate increases.[23]

Excess capacity. State utility commissions have allocated excess capacity costs to utility shareholders in at least a dozen cases in recent years.[24] They have adopted a wide variety of disallowances, ranging from total or partial exclusion of new plant from rate base, denial of equity return while allowing a debt return, or excluding a portion of the utility's overall capacity from rate base at the average system cost. With the recent exception of the total exclusion of the Colstrip-3 coal plant from the Montana Power Co. rate base, excess capacity disallowances have withstood court challenges.

FERC, on the other hand, has never excluded excess capacity from an electric utility rate base, although in 1944, FERC's predecessor, the Federal Power Commission, disallowed costs for excess capacity of a natural gas company on the grounds that the expenditures were not used and useful and were "improvident."[25] FERC has always rejected all other petitions for excess capacity exclusions on the grounds that decisions had been prudent.[26]

Imprudence. In general, as FERC Administrative Law Judge Ernst Liebman observed in a recent speech, although imprudence claims have been raised "hundreds of times" in FERC rate cases, "the Commission has rarely made a finding of imprudence--a notable exception being the Columbia Gas Transmission case."[30]

FERC has disallowd imprudent expenditures in two cases involving electric utilities. In addition, FERC followed the lead of state commissions in Minnesota and California in two cases disallowing imprudently incurred extraordinary losses.[27]

Interestingly, two of the elements which FERC found providing "overwhelming evidence" of imprudence in the Minnesota Power & Light case, were the failure of the utility "to secure a performance guarantee or seek damages" from a supplier.[28] "Failure to pursue contractual remedies" was also cited in a Public Service Co. of New Hampshire case.[29]

Recent cases have involved troubling diversions of FERC's approach from practices of state commissions. In a New England Power Co. (NEPCO) cancellation case, FERC overruled Administrative Law Judge Joseph Nacy's finding of imprudence and partial disallowance. Nacy had written:

> "I cannot conceive of this Commission's allowing a utility to sign away its rights of recovery for damages suffered through the imprudence of another [Boston Edison Co.] and justify that surrender as prudent...[S]hareholders would be protected against loss by the utility's ability to pass the loss on to its ratepayers. That would effectively demolish any incentive a utility might have to do anything in a prudent manner..."[31]

Nacy's concern closely followed the rationale of the prior commission prudence disallowances in the Minnesota Power & Light and Public Service Co. of New Hampshire cases. In rejecting that argument, as well as the imprudence findings of the Massachusetts Department of Public Utilities, FERC appears to be reversing past policies and headed toward assigning investment risks almost exclusively to ratepayers.

FERC's decision last year in the Grand Gulf case is even more worrisome. Not only did FERC fail to perform any prudence review, or assessment of excess capacity, but the commission has actively sought to prohibit state regulators from investigating those issues as well. (A commission staff member in Arkansas estimates that the addition of Grand Gulf-1 gave Arkansas Power & Light an astonishing 72 percent reserve margin.)

In virtually every recent instance of a costly new plant coming on-line, state regulators have considered, and generally implemented, disallowances for imprudence and/or excess capacity. (See Table 4). The only recent exception is Duke Power's Catawba-1 plant, which was by far the least expensive nuclear plant to be completed in the post-Three Mile Island era. Duke is generally acknowledged to be among the most competent nuclear construction managers in the country.

To the best of my knowledge, prudence and/or excess capacity investigations are already underway at virtually every state commission expecting to confront rate shock from a new plant in the next several years.

Marketstandards. While it is impossible to quantify at this time, there is a clearly identifiable movement among state regulators and legislators toward replacing or supplementing the prudence standard with more stringent market-oriented standards.

The leading example of this trend was the recent Kansas Corporation Commission (KCC) decision on Wolf Creek, guided by new standards adopted in 1984 legislation. (Appendix A) That bill required rate based investments to be "used and required to be used." It also established 12 standards for judging the "prudence and efficiency" of new plants as part of the valuation process, which looked at final construction costs vs. original costs, costs to construct other plants, and other results-oriented tests.

Out of Kansas Gas & Electric's $1.3 billion investment in Wolf Creek, the KCC disallowed $142.5 million for imprudent construction management. Another $741.4 million was excluded from the rate base as excess capacity, but the company was allowed a return of the investment through depreciation. Finally, $235.9 million was disallowed by reducing the valuation of the used and useful capacity from Wolf Creek's $2700 per kilowatt cost, to the $1290/kilowatt that a coal plant would have cost. Overall, the company still received a 42 percent increase, compared to the 95 percent increase requested.[32]

We do not find the Kansas decision totally satisfying. Excess capacity was judged on the basis of the 1990 projected reserve margin, rather than current reserves. We do not believe a depreciation allowance was necessarily appropriate. And alternatives were certainly likely to be available at lower cost than new coal plant construction. A coalition of 700 small to medium-size businesses presented expert testimony supporting only an eight percent rate increase.

Nevertheless, the Kansas decision was a giant step toward the application of market-oriented standards for new plant construction, which we think is likely to be replicated in other states as well.

The New Jersey Department of Energy recently published an Energy Master Plan which established strict market-based standards for evaluating utility central station additions. Allowable plant costs would be determined by a mix of the least-cost alternatives available, including conservation investments and cogeneration purchases. In cases where a utility is reluctant to purchase cogeneration because of excess capacity, the plan would set up an auction process whereby the utility would be required to accept the lowest bids. It may then have to bid down the price of its own plant, or see it removed from the rate base as no longer used and useful. (Appendix B)[33]

In Massachusetts, hearings have been opened to evaluate a similar proposal. In California, negotiations are already taking place among Pacific Gas & Electric, the Public Utility Commission staff and intervenors to price the Diablo Canyon plant at the utility's avoided cost. In Michigan, citizens are likely to be voting on a ballot measure (Appendix C) this November amending the state constitution to establish market-based standards for new power plants in that state.

FERC's policies, shifting risk and costs onto ratepayers in virtually every ratemaking area, stand in sharp contrast then to regulatory practices and trends in the states. According to a December 1984 report of the National Regulatory Research Institute:

> "For many electric utilities, regulation of wholesale rates by [FERC] is increasingly viewed as more 'responsive' than the regulation of their retail rates by state commissions, and thus provides an incentive for exploring alternative means of coming under FERC regulation. FERC policies and procedures are viewed as considerably more favorable in a number of key ratemaking areas such as use of a future test year, minimum suspension periods, fuel adjustment clauses, inclusion of CWIP in rate base, and rates-of return...."

The ultimate litmus test for assessing regulatory balancing of ratepayer versus shareholder interests is the ratings of Wall Street investment houses. FERC is included in the category most favorable to investors in every recent ranking, and stands alone at the top the class in Merrill Lynch's grade book. (See Table 5.)[34]

FEDERAL PRE-EMPTION OF STATE REGULATION

FERC's attempted pre-emption of state regulation is the most disturbing aspect of all its recent activities. In addition to the Grand Gulf case, FERC is attempting to prevent state regulators from reviewing prudence in cases in Kentucky, West Virginia and North Carolina [35].

The justification for federal pre-emption springs from what has become known as the Narragansett Doctrine. In 1977, the Rhode Island Supreme Court struck down a state commission ruling blocking the Narragansett Electric Co. from passing through costs to ratepayers for power the utility had purchased from the New England Power Co. (NEPCO). The commission had ruled the costs were "unreasonable" and "strikingly" or "glaringly unfair." [36]

A number of other state and federal courts have made similar findings, ruling that state regulators have no choice but to accept that FERC-approved costs are reasonable, and pass them on to retail ratepayers.[37] Two district court decisions in the Grand Gulf case have supported federal pre-emption over the output of that plant. The Supreme Court is currently hearing a case involving some of the same pre-emption arguments, but in which most observers believe may not resolve the dispute under current law.[38]

The underlying rationale for federal pre-emption stems from the 1927 U.S. Supreme Court case, Public Utilities Commission vs. Attleboro Steam & Electric Co.[39] In that case, the Court established that retail utility sales, being "essentially local" in nature, were properly subject to state regulation, but that wholesale exchanges generally involved inter-state commerce and were "essentially national" in character, and could only be regulated by the federal government under the Commerce Clause. As there was no federal utility regulatory agency at the time, Congress created the Federal Power Commission in 1935 to fill the "Attleboro gap."

The doctrine of federal supremacy was successfully challenged, however, in 1983 in Pike County Light & Power Co. vs. Pennsylvania Public Utility Commission.[40] In that case, the Pennsylvania Commonwealth Court upheld a PUC disallowance of Pike purchased power costs from its parent company, Orange and Rockland Utilities on the grounds that the purchase had been imprudent. The state Supreme Court refused to hear an appeal.

The Pennsylvania commission and court decisions accepted that under the Narragansett Doctrine, FERC had sole jurisdiction to examine the supplier's costs, and establish a wholesale rate for the sale of Orange & Rockland to Pike. Nevertheless, they reasoned, state regulators maintain the authority to rule that the purchaser was imprudent, because it could have obtained more economical sources of power elsewhere, and thereby block passing the costs on to retail customers.

Moreover, FERC itself has supported state prudence reviews over wholesale purchased power costs several times. In a 1981 Philadelphia Electric Co. case, FERC, approving a contract between utilities, noted:

> "[W]e wish to make it clear that our decision to accept the contract... does not, in our view, bind us or the Pennsylvania Public Utility Commission to any particular treatment of these items in the cost of service for wholesale and retail requirements customers of [the purchasers]....We do not mean by this order to prejudge, for our own purposes or those of respective state commissions, a determination of the prudence of either party entering into this transaction.[41]

In another case approving an Atlantic City Electric (AC) power purchase from Pennsylvania Power & Light (PP&L), FERC stated:

> [We] wish to make clear that our decision to accept the agreement for filing is premised on the fact that the formula rate for this jurisdictional sale will not produce excessive revenues. Our decision is not, however, based on a determination that AC's purchase is prudent.[42]

In denying to rehear the case, FERC said:

> "We do not view our responsibilities under the Federal Power Act as including a determination that the purchaser has purchased wisely or has made the best deal available. However, these are legitimate concerns of the State commissions and this Commission as well in determining whether purchases reflect prudently incurred expenses for purposes of determining the purchase's rates for sales to others.

FERC has also reiterated the same position in at least two other cases.[43]

We find the logic of Pike and related decisions affirming state authority to determine the prudence of wholesale purchases totally compelling. We do not believe that FERC should have any authority over the prudence of the retail utility's rates.

Imagine a state utility commission, if you will, not only ruling on a rate hike request from a retail utility, but also trying to regulate how the utility's customers will pay it. Picture the outcry that would ensue from a regulatory agency trying to tell Consolidated Widgets whether it should pay for the rate increase by changing its modernization plans, or by raising widget prices, or by taking it out of stockholder dividends. Whether the Jones family should pay its electric increase out of its savings or checking account. Nothing would unite liberals and conservatives faster in a populist uprising against over-regulation.

Yet that is exactly what FERC is attempting to do with Grand Gulf. FERC's responsibility is to examine a producer's costs and determine that the price it charges its customers are just and reasonable, on the basis of the prudence and/or used and useful standards. The purchasing company has an obligation to pay the approved price, but whether it does so from its own profits, or by passing the charges on to someone else should be of no concern to FERC.

If the purchasing company happens to be regulated by a state utility commission, it is then that commission's duty to examine whether the firm has acted prudently in its business decisions. If so, it may be entitled to pass costs on to its customers. If not, it must absorb them itself. There are no conflicts of inter-state commerce, and no "national interest," because the pruchaser is still obligated to pay the producer.

Now the question is certainly likely to arise: what happens if the wholesaler is a wholly-owned subsidiary of the producer, or they are both wholly-owned subsidiaries of the same parent, as in the Grand Gulf situation? In that case, it may be argued, there may not be any separate shareholders of the wholesaler, and a decision to penalize that company will necessarily penalize the producer and thereby allow state regulators *de facto* to frustrate FERC's regulatory authority.

So be it. *Utility companies should not be allowed to organize their corporate structure for the purpose of circumventing legitimate state regulatory authority.* If there are other--respectable--reasons for organizing separate generating companies (and many doubt that there are), then utilities may still want to create them to acquire those benefits. But escaping state regulation over retail rates must not be one of them.

Yet that is precisely what a number of utilities are attempting to do. Utilities have made no secret of their frustration with state commissions increasingly threatening or implementing disallowances from imprudence and excess capacity.[44] For a number of years, the literature has been filled with discussions of how utilities could circumvent state regulators in order to promote investment in new plant construction.

Several years ago, the U.S. Department of Energy launched a project to actively help the utility industry explore alternatives to state regulation. In a speech to an Edison Electric Institute Chief Executive Officer conference, the project's coordinator, J. Hunter Chiles, said:

> "We are convinced that your industry is under-investing... Simply deferring to the states doesn't solve the problem, because in many respects traditional state institutions are the problem," explaining that the "regulatory decision-making process... appears to be institutionally incapable of pursuing long-run cost minimization and which seems instead to be chronically and almost pathologically fixated on competing notions of political equity."[45]

Two alternatives suggested by Chiles:

> "First, we could propose federal legislation allowing utilities, at their option,,to form separate regional generating companies, subject to FERC bulk power generation. This would create some measure of competition among regulatory jurisdictions, without pre-empting the states...
>
> Alternatively, we could proposed federal legislation that would replace both FERC and state regulation by establishing regional regulatory bodies... Under this approach, states would give up much of their authority to their regional body, but would simultaneously bring wholesale rate regulation much closer to home."

To be fair, Chiles' recommendations also included structural reforms to mandate public participation in reviewing utility supply plans in exchange, of course, for guaranteed returns.

The "founding father" of the regional regulation concept, according to Chiles, was Larry Wallace, then Chairman of the Indiana Public Service Commission and President of the National Association of Regulatory Utility Commissioners. Wallace's prime concern was also that "the existing framework may constitute a major hindrance to the financing at reasonable cost of timely construction of additions and replacements to capacity."[46]

Among the advantages of regional regulation, according to Wallace, would be the facilitation of "joint ventures for constructing costly facilities" and removing "some of the adversarial characteristics and litigiousness that encumber present regulatory practices." Governors were identified by Wallace as the prime constituents to whom regional regulation should appeal.

> "The reluctance of a governor to abdicate state regulatory authority to a federal regional agency is certainly easy to understand and empathize with, but most governors should embrace with open arms a regulatory process accountable to them, but providing insulation from the no-win political problems arising from regulation of electric utility rates by state regulatory agencies."[47]

While the Working Group proposals were derailed by the new Secretary of Energy Donald Hodel, utilities have needed no legislation to pursue the generating company strategy. "Transferring jurisdiction to the FERC is increasingly viewed as one means of risk avoidance or minimization," states the NRRI's Narragansett Doctrine report.

Last year, generating companies were spun off from Tucson Electric, Public Service of New Mexico, Eastern Utilities Associates, and South Carolina Electric & Gas.[48] Consumer groups fear that planned utility mergers in Ohio and Kansas could become vehicles for escaping state regulation through generating companies.

CONCLUSIONS & RECOMMENDATIONS

To reiterate, the fundamental lesson that must be learned from the failures of the last decade is that risk must be assumed by those responsible for making decisions. This lesson applies both to regulatory standards and regulatory jurisdiction.

The process of regulation--allocating risk between ratepayers and investors--itself involves risk-laden decisions. Will approving a rate increase cause unacceptable economic hardship for consumers and businesses? Could a rate increase depress utility sales enough to cause a utility "death spiral?" Could denial of increases cause unacceptable increases in the cost of capital?

Federal pre-emption removes these decisions far from those who must bear the consequences. We are by no means satisfied that the states are shifting as much risk onto utilities as we feel would be equitable and provide the proper incentives for the most efficient and economical electric system possible. But they are moving in the right direction. And as they fully experience the economic consequences of the last round of utility over-building, they will continue moving in that direction.

FERC now regulates only about 10 percent of all electric revenues, so the overall consequences of its more generous policies toward utility investors have been relatively small and localized to date. But a major shift toward generating companies coming under FERC regulation, however, could have grave economic consequences. With a virtually guaranteed return, regardless of the value of the investment, billions of dollars would likely again be poured into uneconomic new power plant construction.

In order to head off any such scenario now, we recommend:

1. Legislatively affirming the Pike doctrine by explictly investing state regulatory commissions with exclusive jurisdiction over retail

ratemaking, including the assessment of all retail utility purchases and investments using applicable state standards. Bills introduced by Senator Dale Bumpers in the Senate (S. 1149) and by Representative Tommy Robinson in the House (H.R. 931) provide good starting points and should be given full legislative hearings. This approach has been endorsed by both the National Association of State Utility Consumer Advocates and the National Association of Regulatory Utility Commissioners.

2. Consider mandating the stricter application of the used and useful standard and/or marketoriented standards by FERC. This would provide fairer and more effective regulation for wholesale transactions, and would shrink the gap between federal and state regulation.

3. Alternatively, consider requiring FERC to take judicial notice of standards and actions adopted by the states having jurisdiction over the retail rates of the utilities in question. This would eliminate any gap between federal and state regulation and the price-squeeze that wholesale purchasers sometimes find themselves in when FERC assigns them costs which state regulators do not assign to utilities they may be competing with.

These actions are critical if we are to avoid repeating the mistakes of the past, and saddling future ratepayers with additional burdens from a new round of excessive plant construction. As Claudia Rosett, managing editor of Policy Review, and Roman Weil, professor of accounting at the University of Chicago, wrote in an op-ed appearing in The Wall Street Journal of October 9, 1984:

> "Cushioning the blow to shareholders... new investors would flock around competing for the chance to benefit again at the expense of ratepayers. With such money drawn in, the utilities would be prone to engage in wasteful products in the future--which is just what the current crisis should teach us to avoid.... It would be folly to overlook the silver lining which is the chance to organize incentives so that excessive costs will be less likely to plague the industry again."

NOTES

[1] See Nuclear Plant Cancellations: Causes, Costs, and Consequences, Energy Information Administration, DOE/EIA-0392, April 1983. Since that report, additional abandonments include Marble Hill 1 and 2, Midland 1 and 2, Zimmer, Hartsville A-1 and A-2, Yellow Creek 1 and 2, River Bend 2, Clinton 2, Skagit 1 and 2, Grand Gulf 2.

[2] Summer 1985 peak was 457,449 MW; utilities net generating capability of 613,769 megawatts at peak, according to the Edison Electric Institute. Peak demand growth increased by less than one percent in 1984 and 1.5 percent in 1985.

[3] Assuming desired 20 percent reserve margin. Excess capacity at $1000/kw. 20 percent fixed charge rate. Excess costs would equal (613,769-(1.2*457,449))MW*$1000000/MW*.2 = $13 billion.

[4] From Rate Shock. The same estimate was also arrived at independently by Aaron Gurwitz and Daniel Chall, "Nuclear Power Plant Construction: Paying the Bill," FRBNY Quarterly Review, Summer 1984; also a Los Alomos study found that nuclear plants under construction would raise rates an average of 23 percent of 1983 levels, the same as the estimate made in Rate Shock.

The annual overcharges can be expected to decrease over time, as the plants are depreciated, alternative fuel costs rise, and new capacity becomes needed. We have estimated that the lifecycle costs for the nuclear units under construction will exceed the costs of existing generation sources by about $200 billion in constant dollars. Charles Komanoff has calculated that the nuclear plants will cost about $65 billion more than new coal plants would have cost over their projected operating lives.

[5] For additional discussion of the prudence standard, see "The Prudent Investment Test in the 1980s," National Regulatory Research Institute, NRRI-84-16, April 1985.

[6] The used and useful standard actually predates the use of the prudence standard in utility law. It was first used by the U.S. Supreme Court in Smyth v Ames in 1898.

[7] E.g., Susan Shanaman, former Pennsylvania PUC Chair: "The PUC serves as the force of the marketplace in Pennsylvania's utility industry." In "Why the PUC decided against Limerick 2," The Philadelphia Inquirer, May 24, 1982.

Of course, regulated firms also face regulatory risks that are imposed on them, such as changing safety standards. Arguably, utilities should not have to bear these entire risks alone. To a large extent, however, regulatory risk can and should be anticipated by utilities when they make certain decisions, such as to build a nuclear plant. Many utilities, for example, in evaluating whether continued construction would be economical in the period after the Three Mile Island accident, refused to revise nuclear cost estimates upward to account for likely new regulations. Now they say that they should not be held at all accountable for increased regulatory costs imposed on them by that accident.

[8] For a very interesting study on utility forecasting over the last decade, see William Huss, "Can Electric Utilities Improve Their Forecast Accuracy? The Historical Perspective," Public Utilities Fortnightly, December 26, 1985, p. 37.

Huss describes his study, at the Battelle Columbus National Laboratory examining forecasting methods and results of major utilities over the last ten years. Battelle found a major shift from trend-line forecasting to econometric forecasting over that time, with basically no improvement in accuracy.

End-use forecasting, which has been advocated and used by consumer-oriented forecasters for many years, was found to "clearly outperform all other techniques." Nevertheless, less than five percent of utilities used end-use techniques in 1980, with less than 14 percent utilizing them even in 1984.

[9] Amory Lovins estimates that tax subsidies can pay for up to 40 percent of the cost of a nuclear plant. See H. Richard Heede, Richard E. Morgan and Scott Ridley, "The Hidden Costs of Energy," Center for Renewable Resources, October 1985.

[10] National Economic Research Associates, "NERC Summary Load Forecasts: A Retrospective Appraisal and Technical Analysis," Electric Power Research Institute, EA-4355, December 1985.

[11] Charles Studness, "1985--A Fifth Successive Year of Electric Utility Financial Progress," Public Utilities Fortnightly, January 23, 1986, page 41.

[12] Charles Studness, "Electric Utility Dividend Changes and Investor Returns During 1985," Public Utilities Fortnightly, February 6, 1986, p. 46.

[13] See Energy Information Administration, Investor Perceptions of Nuclear Power, DOE/EIA-0446, May 1984.

[14] "Missouri PSC Adopts 8-Year Phase-In for UE Plant; Prudence Major Issue," Electric Utility Week, April 8, 1985, p. 1.

[15] Bill Paul, "Brokers May Shift Utility Recommendations to Reflect the Market Value of Power Plants," Wall Street Journal, March 3, 1986.

[16] Paul Markowitz and Joseph Kriesberg, Least-Cost Electrical Planning: Is There Really a State Movement? Critical Mass Energy Project, December 1985.

[17] "35 Utilities Exceed Allowed Returns; Regulation Reaction Varies Widely," Electric Utility Week, April 1, 1985, p. 1.

[18] E.g., see "Which should utilities adopt-the high or low load growth scenario?" Public Utilities Fortnightly, February 20, 1986, p. 53

[19] Warren Samuels, "A Consumer View on Financing Nuclear Plant

Abandonments," Public Utilities Fortnightly, January 10, 1985, p. 24.

[20] FERC Monitor, Vol. II, No. 13, p. 9 6/28/82.

[21] Jerry Pfeffer and William Lindsay, The Narragansett Doctrine: An Emerging Issue in Federal - State Electricity Regulation, National Regulatory Research Institute, Occasional Paper No. 8, December, 1984, p. 53

[22] See Energy Information Administration, op. cit. A five year amortization period results in utility investors absorbing 19 percent of total cancellation costs, ratepayers 49 percent, and income taxpayers 32 percent (because of tax writeoffs). A 10 year amortization assigns 28 percent of the total to investors, 30 percent to ratepayers, and 43 percent to taxpayers; a 20 year amortization--35 percent to shareholders, 16 percent to ratepayers and 49 percent to taxpayers.

[23] In Ohio, PUC has allowed a higher than normal rate of return to compensate for the increased risk. An Indiana proposal would similarly deny recovery of Marble Hill costs, but allow Public Service of Indiana an "emergency" rate hike equivalent to amortizing the plant's cost over about 20 to 25 years.

[24] For a thorough review of theory and practice of excess capacity decisions, see Roger Colton "Excess Capacity: Who Get the Charge From the Power Plant?" Hastings Law Journal, Vo. 23, No. 5/6, May/July 1983, p. 1133 and Commission Treatment of Overcapacity in the Electric Utility Industry, National Regulatory Research Institute, NRRI-84-10, September 1984.

[25] "Any attempt to saddle excessive costs for depreciation and return on domestic customers would be manifestly unfair and unreasonable where natural gas companies have created excess capacity neither used nor useful in rendering present service but originally constructed because of a hope for large industrial sales, the undertaking having been found to be an improvident venture." Re Godfrey L. Cabot, Inc. (1944) 56 PUR (NS) 113.

[26] "The commission reaffirmed its conclusion that a successful challenge to a power company's rate base valuation for generating capacity must be based on showing that the company acted imprudently in planning such capacity. Re Southern California Edison Co. (1978) 23 PUR4th 472, Opinion No. 821-A.

[27] Michael Small, "FERC Electric Rate Primer," Energy Law Journal, Vol 5, No. 1, 1984, p. 110

[28] "The combination of self-dealing, the selection of a questionable pollution control process, the failure either (or both) to secure a performance guarantee and to seek damages constitutes overwhelming evidence of imprudence." Minnesota P&L Co. Opinion No. 87, 11 FERC P. 61,313 at 61,659-60 (1980)

[29] Public Service Co. of New Hampshire, Opinion No. 37, 6 FERC P. 61,299

at 61,714-15 (1979).

[30] "Doctrine of Prudence in the Regulation of Public Utilities"--at legal seminar of APFA in Seattle in Oct. 84. FERC Monitor, November 29, 1984, p. 11. Vol IV, No. 24

[31] FERC Monitor, July 12, 1984, Vol. IV, No. 14, p. 13.

[32] Dockets No. 120,924-U and No. 142,098-U.

[33] "N.J. Policy: Oust Plant From Rate Base if Cogeneration is Cheaper and Cleaner," Electric Utility Week, December 23, 1985, p. 1.

[34] "FERC gets highest marks in PSC performance ratings," Electrical World, October 1985, p. 26.

[35] "FERC Tells High Court That State Regulation of Interstate Rates is Not Allowed," Electric Utility Week, February 10, 1986, p. 9. "AEP Challenges Kentucky PSC Order That Impedes FERC-Approved Pacts," Electric Utility Week, December 24, 1984, p. 1. (Case No. 9061); "W.Va. PSC Cannot Reject FERC-Approved AEP Transmission Line Deal, Says Judge", Electric Utility Week, March 4, 1985, p. 1; "FERC Rules on Prudence, Other Jurisdictional Issues in Holding Co. Cases," Electric Utility Week, September 16, 1985, p. 7.

[36] Carl Ecbelman, "The Narragansett Decision and Its Aftermath," Energy Law Journal, Volume 6, No. 1, 1985, p. 33.

[37] In addition to the above, see Thomas Pietrantonio, "The Preemptory Effect of an FERC Rate Approval," Public Utilities Fortnightly, August 16, 1984 (argues that Pike was a judicial error); Andrew O'Neill, "Retail Electric Rates: Drawing the Line between Federal and State Authority Under the Commerce Clause," Public Utilities Fortnightly, October 27, 1983; Louis Flax, "Has the Supreme Court Pulled the Rug from Under the FERC's Electric and Natural Gas Regulation?" and Michael Anderson, "The Role of the States in Energy Regulation,"Energy Law Journal, Vol. 4, No. 2, 1983.

[38] "U.S. Supreme Court Seen Choosing Wrong Case to Decide Federal/State Issue," Electric Utility Week, January 27, 1986, p. 6.

[39] Rhode Island Pub. Utilities Commission v Attleboro Steam & Electric Co. (1927) 273 US 83, PUR1927B 348 (Attleboro)

[40] Pike County Light & Power Co.-Electric Division v Pennsylvania Pub. Utility Commission (1983)-- Pa Cmwlth --, 465 A2d 735.

[41] Philadelphia Electric Co., 15 FERC at 61,601 (1981).

[42] Pennsylvania Power & Light, 23 FERC P. 61,005 (1983).

[43] Pacific Power & Light Co., 27 FERC P 61,080 (1984); Kentucky Power Co. Docket No. ER84-579-001, Order Clarifying Prior Order, slip op. at 3 (Nov. 23, 1984).

[44] Utilities have been making a concerted argument in the press and

before Congress for the last year that stingy state regulators are preventing the construction of needed new capacity, threatening the country with blackouts and brownouts in the 1990s. See Senate Energy Committee Hearings, "When Will the Lights Go Out?", July 23, 1985.

[45] J. Hunter Chiles, III, "Towards a Workable Consensus on Electricity: Breaking the Deadlock," Kansas City, Missouri, September 9, 1982.

[46] Larry Wallace, "Reregulation of the Electric Utility Industry," A Neglected Alternative," Public Utilities Fortnightly, November 25, 1982, p. 13.

[47] It is worth remembering that Larry Wallace was a major force behind attempting to continue financing construction of the Marble Hill nuclear plants, until Indiana Governor Robert Orr took the key decisions on that plant's fate out of the hands of Wallace's commission, and placed them in a special panel of independent business executives. That panel's recommendation to cancel means that Public Service of Indiana ratepayers now face an 8 percent rate hike. Had Marble Hill been completed, it would have required a rate increase of over 100 percent.

[48] "Consortium planning 2000 MW plant in NM steps up bid for power sales," Electric Utility Week, October 7, 1985, p. 7; "Alamito sets March 5 vote on leveraged buyout by management group," Electric Utility Week, February 17, 1986, p. 5; "SCE&G is 1985 Utility of the Year," Electric Light & Power, November 1985, p. 1; "A New Kind of Game for Electric Utilities", Public Utilities Fortnightly, July 11, 1985, p. 4.

ANSWERS TO SUBMITTED QUESTIONS

1. In ratemaking cases within its jurisdiction, should FERC, as a routine matter, address the prudency of the costs incurred by a utility with respect to a new or abandoned power plant?

FERC should most definitely address the prudence and used and usefulness of all investments by utilities selling inter-state wholesale power. Where state commissions have already addressed those issues for plants within their jurisdiction, FERC should take judicial notice of those decisions.

FERC should not address the prudence or any other aspect of decisions made by the purchasing utility. That responsibility should belong exclusively with local regulatory authorities having jurisdiction over retail rates.

See especially page 24 of the testimony for additional discussion.

2. What standards should be applied by a regulatory commission, state or federal, in reviewing the prudence of utility costs?

We support the Kansas legislative broadening of the prudence standard beyond looking exclusively at decisions at the time they were made, to include examining the results of those decisions. At the very least, results (such as a comparison of final cost of a facility to original cost, or of the cost of a facility to others built during the same period, etc.) should be used to establish a presumption of imprudence.

The prudence standard should not pre-empt the use of stricter standards, such as a used and economically useful test.

See page 5 ff.

3. Under what circumstances may an abandoned or cancelled plant be deemed "used" or "useful"? Under what circumstance should consumers pay part or all of the costs of an abandoned or cancelled plant?

Abandoned or cancelled plants are never used or useful and should never be eligible for inclusion in the rate base. Under conditions where a thorough public review, with well-funded intervenors, as part of an overall least-cost planning process has been carried out, regulators may consider a return of but not a return on prudently managed construction expenditures.

See also page 11.

4. Do you believe that joint State/Federal boards should be formed to review the prudence of a utility's investment in a new or abandoned power plant?

We think it is essential to maintain a bright line between state and federal jurisdiction as defined above. Where it is clear that both state and federal regulatory agencies will have jurisdiction over valuating a new plant (because the owner(s) will be selling output directly to both wholesale and retail markets), it may be most efficient for them to voluntarily consider pooling resources to conduct prudence reviews. The states of Arizona, New Mexico, Texas and California are currently cooperating in such a way in a prudence review of the Palo Verde plant. Each will, and should, maintain authority over rate-making within its jurisdiction.

5. What authority should State regulatory agencies have to review the prudence of a purchase of power by a utility a wholesale rate approved by FERC?

Exclusive and complete authority. See page 11ff.

6. Should the Narragansett doctrine be modified legislatively and, if so, in what manner?

We prefer to see the Pike doctrine--granting state commissions authority to review the transactions of the purchasing utility--and the Narragansett Doctrine--granting FERC the exclusive authority to regulate the selling utility--as complementary and not in conflict. In that sense, the Narragansett doctrine per se needs no legislative modification. Legislation guaranteeing this state authority, along the lines of HR 1146 and S 939, is essential, however, to clarify and reconcile conflicting court opinions in this area.

7. Please identify the jurisdictions in which consumer rates for power have recently increased significantly as a result of the inclusion in the ratebase of the costs associated with a new or abandoned plant.

See Tables 1 and 2.

8. Should a regulatory commission disallow costs of a new plant if that plant represents excess capacity?

Yes. See pages 5ff.

9. Please comment on the use of rate increase phase-ins to recover the costs of a new or abandoned plant.

Valuation of a utility rate base using original cost less depreciation inherently loads costs from a new plant onto ratepayers in the early years of the plant's life. This procedure creates a mismatch between costs and benefits since the capital costs are highest during the earliest years, when fuel savings are likely to be low, and lowest during later years, when fuel savings benefits likely to be higher.

Phase-ins are appropriate to levelize costs attributable to front-loading, but only after costs of imprudence and excess capacity are allocated to investors. Use of phase-ins as substitutes for allocation of costs to investors is not appropriate.

10. Alfred Kahn, among others, has described post hoc prudence reviews and large-scale cost disallowances as a break from the "historic pact" between public utilities and ratemaking authorities. That pact involves an obligation on the part of the utility to meet its service area's power needs, in return for which the ratemaking authority guarantees the utility a rate of return on its investment. Do you agree with Kahn's analysis? If so, do you believe that the "historic pact" itself may need revision, and, if so, in what ways?

The obligation for a utility to meet power needs does not mean that it should be insulated from any business risk. (See page 7.) Certainly, there has never been any stated or implied agreement that utilities should recover imprudently incurred expenditures. In fact, the stricter standard of allowing return only on used and useful property has an even longer history, dating to the Smyth v. Ames Supreme Court decision in 1898. Recent court decisions have reaffirmed the principle that there is no guarantee of profitability.

Until the last two decades, the electric utility industry was a declining-cost industry, as technological improvements enabled the more efficient generation of electricity at lower rates. Naturally, under these conditions, one would not expect to see very large disallowances. The current generation of nuclear reactors, which cost more than 10 times as much as earlier plants, have increased in cost at more than twice the rate of fossil fuel plants, are being completed at costs as much as 10 to 20 times original estimates, and which differ as much as five times in cost per kilowatt even among plants being completed in the same time frame, is clearly responsible for much of the present concern.

Many utilities may well have operated under the false assumption that they would be guaranteed recovery of whatever they spent, given a regulatory history that tended to do just that. That attitude is clearly in large part responsible for the current situation, and just as clearly, must be changed by appropriate regulatory treatment allocating risk and consequences to investors.

Perhaps, however, the "pact" between utilities and regulators to which Mr. Kahn refers has something to do with the fact that all five former chairmen of the New York Public Service Commission since 1970 now work for the utility industry they once regulated, according to testimony to the New York State Assembly in May 1985 by Cornell University economist Duane Chapman.

TABLE 1
PLANT CANCELLATION TREATMENT BY STATES*
(Over $100 million sunk costs)

STATE	UTILITY	PLANT	COST (millions)	AMORT?	PERIOD (Years)	RETURN?
CT	United Illuminating	Seabrook 2	104	Full	10	No
IN	NIPSCO	Bailly 1	191	No(a)		
MA	Boston Edison	Pilgrim 2	278	Part	13(b)	Yes(b)
MI	Consumers Power	Marysville(c)	104	Part	10	No
		Midland 1 & 2	4000	(d)		
NJ	Jersey Central P&L	Forked River	395	Full	15	No
		TMI-2	184	Full	18	No
	Public Service E&G	Atlantic	301	Full	15	No
		Hope Creek 2	291	Full	15	No
NC	Carolina P&L	Harris 2	315	Full	10	No
		Harris 3 & 4	183	Full	10	No
	Duke Power	Cherokee	633	Full	10	No
	Virginia Elec & P	North Anna 3&4	626	Full	10	No
OH	Cincinnati G&E) Dayton P&L) Columbus & South.)	Zimmer	1700	No(e)		
OK	Public Service Ok.	Black Fox	251	Full	10	No(f)
	Portland GE	Pebble Springs	132	No		
		Skagit	138	Part	5	No
PA	Met Ed	TMI-2	369	Full	13.3	No
	Penn Elec	TMI-2	172	Full	8.7	No
SC	Carolina P&L	Harris 2,3,4	498	Full	10	No
	Duke Power	Cherokee	633	Full	10	No
TX	Houston L&P	Allens Creek 1	362	Part	10	No
		Allens Creek 2	12	Full	5	No
	Virginia Elec & P	North Anna 3,4	345	Full	15,10	No
WA	Puget Sound P&L	Skagit	178	Part	10	No

(a) NIPSCO was originally allowed by the PSC to amortize costs over 15 years. Decision was overturned recently by state Supreme Court, disallowing any recovery.

(b) DPU ruled that plant should have been cancelled in July 1980 and denied recover of costs from then until actual cancellation 15 months later as imprudent. Denied recovery of pre-cancellation equity carrying charges (AFUDC). Allowed return on remaining balance a 9.3 percent (cost of debt only).

(c) Coal plant.

(d) Midland case still unresolved. Company has received a $99 million "emergency" rate hike (equal to about 30 year amortization).

(e) Companies required to write off half ($861 million) of sunk costs. Remaining half will accrue finance charges and be used in conversion of unit to coal.

(f) Originally allowed return but subsequently disallowed and refunded.

*No FERC-jurisdictional costs over $100 million.

Sources: Energy Information Administration, supplemented with trade press reports.

TABLE 2
RATE SHOCK FROM NEW NUCLEAR PLANTS

STATE	UTILITY	PLANT	REQUEST (millions)	%	ALLOWED (millions)	%	PHASE-IN (Years)
AR	Arkansas P&L	Grand Gulf 1	330	33%	300	30%	10
AZ	Arizona Public Serv.	Palo Verde 1 (a)	78.2	8.6%	--	--	--
CA	Pacific G&E	Diablo Canyon 1	206 (b)	3.6%	53 (b)	1%	--
	Southern Cal Ed	San Onofre 2,3	361	7.8%	(b)	--	--
IL	Commonwealth Edison	Byron 1	544.6	12%	494.8	11%	2
	Union Electric	Callaway	78	59%	51	38.7%	8
KS	Kansas G&E	Wolf Creek	371	95%	164	42%	2
	Kansas City P&L	Wolf Creek	110.4	52%	33.7	16.5%	--
LA	Gulf States Util.	River Bend	360.1	39.2%	--	--	--
	Louisiana P&L	Waterford			295	21.7%	5
		Grand Gulf	113.9	8.4%	94	6.9%	10
	New Orleans PS	Grand Gulf	118	36.8%	28.3	8.8%	--
MI	Detroit Edison	Fermi 2	807	35%	--	--	--
MO	Union Electric	Callaway	639	65.5%	444	45%	8
MS	Miss. P&L	Grand Gulf	505	68.2%	505	68.2%	10
NC	Duke Power	Catawba 1	292	17%	292	17%	10
NJ	Public Service E&G	Hope Creek	569	18.8%	--	--	--
	Atlantic City Elec.	Hope Creek	91.9	16.1%	--	--	--
PA	Philadelphia Elec.	Limerick 1	670.7	28.2%	--	--	--
	Penna. P&L	Susquehanna 2	228	16%	126	9%	--
TX	Gulf States Util.	River Bend	200.6	24.9%	--	--	--

(a) 50 percent of plant already in CWIP.

(b) Interim rate hikes pending prudence determinations.

TABLE 3
ECONOMIC IMPACT STUDIES

MI	Detroit Ed	Fermi 2	35,000 jobs lost
MO	Union Elec KCP&L	Callaway) Wolf Creek)	40,000 jobs lost
NH	Public Serv.	Seabrook	19,000 jobs lost
NY	LILCO(a)	Shoreham	35-49,000 jobs lost
			37,000 families disqualified from mortgage market
			2,000 home foreclosures
			11,000 families pushed below poverty line
PA	Phila. Elec.	Limerick 1	19,000 jobs lost

Sources:
New York, New Hampshire: Greg Palast, Union Associates
Michigan: John Stutz, Energy Systems Research Group
Missouri: Robert Klepper
Pennsylvania: Arie Schinner, Wharton School of Economics

TABLE 4
MAJOR DISALLOWANCES

STATE	UTILITY	PLANT	COST/ UTILITY (millions)	DISALLOWED FROM RATE BASE (millions)	REASON
AR	Arkansas P&L	Grand Gulf	1260	151	Settlement (a)
CA	Pacific G&E	Diablo Canyon 1,2	5400	1000 (b)	Imprudence
	Southern Cal Ed	San Onofre 2,3	4500	536 (c)	Imprudence
				450 (c)	"Unreasonable risks
IL	Commonwealth Ed	Byron	2100	101.5	Imprudence
KS	Kansas G&E	Wolf Creek	1300	142.5	Imprudence (d)
	Kansas City P&L			741.4	Excess capacity
				235.9	Revaluation
LA	Louisiana P&L	Waterford 3	2840	284	Imprudence settlement
		Grand Gulf	972	175	Settlement (e)
MI	Detroit Edison	Fermi 2	3075	294.3(f)	Imprudence
MO	Union Electric	Callaway	2800	384	Imprudence
NY	Long Island Lighting	Shoreham	4500	1350	Imprudence
PA	Pennsylvania P&L	Susquehanna 2	3000	No return on equity	Excess capacity
	Philadelphia Elec.	Limerick 1	3800	1600 (g)	Imprudence
TX	Houston L&P et. al.	South Texas 1,2	5500	1800	Imprudence

(a) The Arkansas Grand Gulf settlement calls for Arkansas P&L shareholders to absorb 12 percent of Grand Gulf costs initially, rising to 22 percent over 10 years. The settlement is not really equivalent to a full imprudence disallowance, however, since the company can sell its retained share on the wholesale market and retain any revenues from the sale.

(b) Recommended by Attorney General.

(c) Recommended by PUC staff

(d) Disallowances applicable to each utility.

(e) Settlement calls for Louisiana P&L to absorb 18 percent of costs. Same stipulation as above on sales.

(f) Recommended by Administrative Law Judge.

(g) Recommended by PUC staff.

(h) Recommended by PUC audit. Includes direct costs only, no carrying charges.

'Prudent' Duke gets 100% of Catawba-1 cost in rate base

The entire $1.946-billion that Duke Power Co invested in its Catawba-1 nuclear powerplant has been allowed into rate base as a result of the North Carolina Utilities Commission's (NCUC) ruling last month that the utility was "prudent and reasonable" in building the 1,145-MW plant.

The NCUC, however, levelized Duke's recovery in rates of payments it makes to four municipal and cooperative systems. This essentially pays back to the four systems the money they invested in the building of the plant.

"We are pleased that the commission recognized Catawba Unit 1 was a good investment for our customers and that the sale of the station and the repurchase of electricity from the other owners was in our customers' best interest," says a company spokesman.

"But we are disappointed that we are not allowed to collect the costs associated with Unit 1 as they occur, and that they must be levelized over the lives of the sale contracts," he says.

The NCUC decision granted Duke a $164.9-million, 9.52% rate hike. In addition, the utility was allowed a 14.9% return on equity.

Duke had originally requested $340-million and a 16.25% return on equity. Duke later reduced this to a $292.8-million request along with a 15.25% return.

LESS NOW, MORE LATER. Under the levelized payments, Duke will recover less than the amount of its cash payments to the two municipal utilities and the two co-ops in the early years, but more of these payments in the later part of the 15-year pay period. With levelization, Duke will recover only $117.8-million initially, but $1.356-billion over 15 years. Without levelization, the utility would have received $175.6-million initially and $1.116-billion over the payment period.

Commenting on the levelized payments, the written NCUC decision says, "it makes sense to levelize the company's capacity capital costs and give rate stability for the period of the payback. Levelization will reasonably apportion such expenses between present and future rate payers who will receive the benefits of the sale of Catawba-1 over the lives of the contract."

Duke opposed levelization arguing that it would ultimately boosts costs, and would "send the wrong price signals."

Catawba was planned in 1973 when Duke's load was growing 10% a year. The plant went on-line June 29, 1985. The Carolina Environmental Study Group (CESG) attempted to 'kill' the plant in 1974, believing that the capacity was not needed.

The group predicted a 1982 peak for Duke of 6,200 MW, while the actual load was 11,145 MW.

"If Duke had built to CESG's predicted peak load," declares NCUC, "the Piedmont Carolinas would be experiencing continued blackouts." ■

FERC gets highest marks in PSC performance ratings

State regulators allowed only $1.2-billion in rate relief in the first half of 1985. This is the lowest amount granted since 1978, according to the latest Salomon Brothers' Inc semiannual review of electric utility regulators. However, the analysts expect a larger amount of rate relief in the second half of the year due to several pending cases involving completed nuclear plants.

The decrease "partially reflects the completion of construction programs and subsequent higher percentages of internally generated cash, which is a positive sign," says the review. "In part, however, decreases result from excess capacity and other disallowances being used as excuses to minimize rate increases." The analysts call these disallowances "a disturbing factor."

DECLINING RETURNS. While the allowed return on common equity for the first half of 1985 of 15.4% exceeded 1984's level, it has been declining from 15.7% during the fourth quarter of 1984 to 15.5% and 15.4% during the first and second quarters of 1985, says the review. This reduction "primarily reflects decreased return on equity."

In addition, a return to normal weather, less rate relief, and the substitution of plants in service for AFUDC have caused earned returns on equity to fall faster than allowed returns. Earned returns on equity have dropped from 15.4% for the 12 months ending June 30, 1984, to 14.7% for full year 1984, to 14.3% for the 12 months ending June 30, 1985, according to the review.

Salomon Bros and two other investment brokerage firms, Merrill Lynch Capital Markets, and Duff and Phelps, continually rank the regulatory commissions to help investors judge performance of regulatory environments (see table). No commissions were placed in the highest category by any of the investment firms. FERC was the only regulatory agency included in the second highest category by all three firms. When ranking commissions, the investment houses consider such factors as allowed return on equity and rate base, the inclusion of CWIP in rate base without an AFUDC offset, the test period, type of rate base, accounting permitted, existence of fuel clauses, the speed with which new rates are granted, and the existence of interim rates. ■

How commissions rate with analysts

	DP	ML	SB
Alabama	IV	1	C–
Arizona	IV	2+	C–
Arkansas	V	1+	C–
California	IV	3+	B
Colorado	IV	2	C
Connecticut	IV	4–	B
Delaware	III	3+	C+
Washington, DC	V	2+	D
Florida	III	4–	B
Georgia	IV	3–	C–
Hawaii	IV	3	C
Idaho	V	3–	C–
Illinois	III	4+	B
Indiana	II	3	C+
Iowa	IV	2	C–
Kansas	IV	2	C
Kentucky	III	3+	C
Louisiana	VI	1	E
Maine	V	1	D+
Maryland	IV	2+	C
Massachusetts	V	2+	C
Michigan	VI	2–	D
Minnesota	IV	4–	C+
Mississippi	IV	1	D
Missouri	V	3–	C–
Montana	VI	1	E
Nebraska	—	2–	—
Nevada	V	3	C
New Hampshire	IV	2+	C–
New Jersey	III	3	C+
New Mexico	II	3	C+
New York	IV	3+	C+
North Carolina	IV	3	C+
North Dakota	V	2	C–
Ohio	IV	3–	D+
Oklahoma	IV	3	C+
Oregon	III	4–	B
Pennsylvania	V	3	D+
Rhode Island	III	2	C–
South Carolina	IV	3	C–
South Dakota	V	2–	D
Tennessee	—	2	—
Texas	III	3	B
Utah	II	3+	B
Vermont	IV	4–	C+
Virginia	IV	3	C–
Washington	V	3	C
West Virginia	V	2–	D
Wisconsin	III	4	B
Wyoming	V	1	C–
FERC	II	5	B

Note:
DP: Duff & Phelps: I is the highest rating, VI is lowest
ML: Merrill Lynch: 5 is highest rating, 1 is lowest
SB: Salomon Bros: A is highest rating, E is lowest
Bold indicates upgrade; italic indicates downgrade

SHALL ENTERTAIN PETITION FOR DECLARATORY RULINGS WITH RESPECT TO ANY PRACTICE WHICH THE PETITIONER BELIEVES SHOULD BE ADDED TO OR REMOVED FROM THE LIST. SUCH PRACTICES SHALL INCLUDE, BUT NOT BE LIMITED TO, INJECTING BAD FAITH DEMANDS INTO THE NEGOTIATION PROCESS, HABITUALLY OR REPEATEDLY FAILING TO MEET REASONABLE REQUESTS FROM A POTENTIAL COGENERATOR FOR MEETINGS, ANSWERS OR DECISIONS, OR FAILING TO BRING TO MEETINGS REPRESENTATIVES KNOWLEDGEABLE ABOUT THE PARTICULARS OF THE COGENERATION PROJECT AND QUALIFIED TO RENDER DECISIONS THAT BIND THE UTILITY IN THE MANNER OF A BUSINESS AGENT. A UTILITY DEEMED TO BE ENGAGING IN SUCH BAD FAITH NEGOTIATION SHALL BE LIABLE TO THE COGENERATOR FOR ALL COSTS PROXIMATELY CAUSED BY SUCH BAD FAITH NEGOTIATION OR DEMANDS, AS DETERMINED BY THE BPU.

9. COGENERATOR MUST HAVE THE OPPORTUNITY TO PROVIDE LEAST-COST ENERGY FOR CONSUMERS.

[Cogenerators have not in the past been able to displace utility-generated capacity, even though the power generated from these sources is more expensive.]

IF A UTILITY REFUSES TO CONTRACT FOR CAPACITY OR ENERGY OR BOTH FROM AN OTHERWISE QUALIFIED COGENERATION FACILITY DUE TO A LACK OF NEED FOR THE POWER, AND IF NO OTHER PURCHASER OF THE POWER IS FOUND BY THE UTILITY WHICH WILL PURCHASE POWER TRANSMITTED TO IT, THE COGENERATION FACILITY MAY BID AGAINST POWER SUPPLIED BY UTILITY-OWNED AND -OPERATED FACILITIES OR OTHER NON-UTILITY PROJECTS. THE UTILITY SHALL SELECT THE POWER SOURCE WHICH AVOIDS THE GREATEST COST OTHERWISE INCURRED BY THE RATEPAYERS OF THE UTILITY. IF THE COGENERATOR IS AGGRIEVED BY THE DECISION OF THE UTILITY, IT MAY PETITION THE BPU FOR A DECLARATORY RULING THAT THE UTILITY SHOULD PURCHASE THE POWER OFFERED BY THE COGENERATOR UPON A FINDING THAT (1) THE POWER THAT WOULD BE DISPLACED COSTS MORE TO PRODUCE OR SUPPLY THAN THE POWER FROM THE COGENERATOR, WHETHER CAPACITY OR ENERGY OR BOTH; AND (2) THE COGENERATOR OFFERS NON-ECONOMIC BENEFITS, SUCH AS ENHANCED SYSTEM RELIABILITY, THE BURNING OF ALTERNATIVE FUELS, THE REDUCTION OF AIR OR WATER POLLUTION OR OTHER ADVANTAGES SUPERIOR TO THOSE FROM THE UTILITY FACILITY OR OTHER NON-UTILITY FACILITIES ON THE SYSTEM.

THE BPU AND THE DOE SHALL REQUIRE TO PURCHASE POWER, CAPACITY OR ENERGY OR BOTH, FROM COGENERATION WHICH IS LESS COSTLY TO RATEPAYERS THAN UTILITY-OWNED OR -OPERATED CAPACITY EXCESS, REGARDLESS OF WHETHER SUCH UTILITY CAPACITY IS IN RATE BASE, WHENEVER THE NON-UTILITY SOURCE WOULD CONFORM TO OR OTHERWISE PROMOTE A LEAST-COST ENERGY STRATEGY. IN MAKING THIS FINDING, THE BPU SHALL FIND THAT THE NON-UTILITY SOURCES PROMOTE A LEAST-COST ENERGY STRATEGY WHENEVER SAID COGENERATION FACILITIES OR INCREMENTS CAN DISPLACE COSTLIER UTILITY FACILITIES. THE BPU SHALL THEN PROCEED TO DETERMINE WHETHER SAID CAPACITY WHICH IS DISPLACED SHOULD BE REMOVED FROM RATE BASE AS NO LONGER USED AND USEFUL.

(Published in the KANSAS REGISTER April 19, 1984)

HOUSE BILL No. 2696

AN ACT concerning social and rehabilitation services; placement agreement with secretary of corrections.

Be it enacted by the Legislature of the State of Kansas:

Section 1. The secretary of social and rehabilitation services is authorized to enter into an agreement with the secretary of corrections concerning the management and utilization of buildings and land currently not being used at state institutions under the authority of the secretary of social and rehabilitation services for the placement of persons in the custody of the secretary of corrections. The secretary of corrections shall provide supervision and security for persons placed under any such agreement.

Sec. 2. This act shall take effect and be in force from and after its publication in the Kansas register.

I hereby certify that the above BILL originated in the HOUSE, and passed that body March 7, 1984.

MIKE HAYDEN
Speaker of the House.
GENEVA SEWARD
Chief Clerk of the House.

Passed the SENATE March 29, 1984.

ROSS O. DOYEN
President of the Senate.
LU KENNEY
Secretary of the Senate.

APPROVED April 10, 1984

JOHN CARLIN
Governor.

STATE OF KANSAS
Office of Secretary of State.

I, JACK H. BRIER, Secretary of State of the State of Kansas, do hereby certify that the above and foregoing is a correct copy of the original enrolled bill now on file in my office.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed my official seal, this 11th day of April, 1984.

JACK H. BRIER
Secretary of State.

(SEAL)

(Published in the KANSAS REGISTER April 19, 1984.)

HOUSE BILL No. 2927

AN ACT concerning regulation of public utilities; amending K.S.A. 66-128 and repealing the existing section.

Be it enacted by the Legislature of the State of Kansas:

Section 1. K.S.A. 66-128 is hereby amended to read as follows: 66-128. ~~Said~~ *The state corporation* commission shall ~~have the power and it shall be its duty to ascertain~~ *determine* the reasonable value of all *or whatever fraction or percentage of the* property of any common carrier or public utility governed by the provisions of this act *which property is* used ~~or~~ *and* required to be used in its services to the public within the state of Kansas, whenever ~~it~~ *the commission* deems the ascertainment of such value necessary in order to enable the commission to fix fair and reasonable rates, joint rates, tolls and charges; ~~and~~. In making such valuations ~~they~~ *the commission* may avail ~~themselves~~ *itself* of any reports, records or other things available to ~~them~~ *the commission* in the office of any national, state or municipal officer or board. For the purposes of this act, property of any public utility which has not been completed and dedicated to commercial service shall not be deemed to be used ~~or~~ and required to be used in ~~said~~ *the* public utility's service to the public, except that, any property of a public utility, the construction of which will be *commenced and* completed in one ~~(1)~~ year or less, may be deemed to be completed and dedicated to commercial service.

New Sec. 2. Nothing in sections 3 to 10, inclusive, of this act shall be construed to limit the authority of the state corporation commission to review and evaluate the efficiency or prudence of any actions, including acquisition of excess capacity, or operating practices of any public utility or common carrier for the purpose of establishing fair and reasonable rates, joint rates, tolls and charges.

New Sec. 3. The commission may require a public utility to defer inclusion of all or any portion of the reasonable value of property determined not currently used and required to be used and may require the phase-in of such value over any period of time and in such increments as it determines to be appropriate. If the commission requires a public utility to defer the inclusion of any portion of such reasonable value and orders a phase-in of such value, it may exclude any or all of the carrying or finance costs incurred after the date of its determination and throughout the period of any deferral or phase-in as so ordered.

New Sec. 4. The state corporation commission, in determining the reasonable value of property under K.S.A. 66-128, and amendments thereto, shall have the power to evaluate the efficiency or prudence of acquisition, construction or operating practices of that utility. In the event the state corporation commission determines that a portion of the costs of acquisition, construction or operation were incurred due in whole or in part to a lack of efficiency or prudence, or were incurred in the acquisition or construction of excess capacity, it shall have the power and authority to exclude all or a portion of those costs from the revenue requested by the utility.

For the purpose of this act, "excess capacity" means any capacity in excess of the amount used and required to be used to provide adequate and reliable service to the public within the state of Kansas as determined by the commission. The commission may in its discretion prohibit or reduce the return on costs which were incurred in constructing, maintaining or operating excess capacity.

New Sec. 5. The state corporation commission may at any time and in its sole discretion, whether or not the facility is still under construction, initiate on its own motion a proceeding to determine in advance whether the costs of such facility were reasonably or prudently incurred, or whether all or a portion of the costs of such facility are or shall be incurred in producing excess capacity under section 4. The proceeding shall be commenced by the commission giving 30 days' written notice of the setting of the hearing of such proceeding to the public utility or utilities involved, and no other motion shall be required, but the procedure, hearing and appeal rights shall otherwise be as specified in K.S.A. 66-101 *et seq.* and amendments thereto.

New Sec. 6. In the event the commission finds that a portion of the costs were attributable either to investment in excess capacity which were incurred due to lack of prudence in facility planning or were incurred due to lack of prudence in plant acquisition, construction or operation, the commission shall exclude that portion of the carrying or finance charges incurred after the date of its finding, and no part of the carrying or finance costs excluded shall ever be or become part of the reasonable value of public utility property so used and required to be used. For the purposes of this section only, a finding of lack of prudence in capacity planning for a facility which in whole or in part represents excess capacity shall not be made by the commission when a siting permit authorizing the construction of the facility has been issued under K.S.A. 66-1,162 and amendments thereto prior to the passage of this act. The commission also shall not authorize the recovery as operating expense or in any other manner of the carrying or finance costs so excluded.

Nothing in this act shall limit the commission's authority to adjust revenue requirements of any public utility if the commission determines the revenue requirement requested results in whole or in part from inefficiency or a lack of prudence.

If the commission determines that a public utility, which generates and sells electricity as its main activity, has borrowed funds in order to pay dividends and such borrowing as the result of lack of prudence, increases the revenue requirement of the utility, the commission may adjust the revenue requirement accordingly.

(continued)

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New Sec. 7. Any public utility subject to the provisions of sections 3 to 8, inclusive, of this act which constructs an electric generating facility and was not required to obtain an advance permit under K.S.A. 66-1,159 *et seq.* shall make and send monthly financial reports to the state corporation commission. Such reports shall include the following information, as of the date of the report, the: (a) Actual costs incurred; (b) total estimated cost of the facility, (c) percentage of the facility which is actually completed, (d) estimated date of first commercial operation; (e) copies of informational filings provided federal agencies having regulatory authority over such construction, and (f) any other information required by the commission. Such reports shall be prepared and certified in the manner and form required by the commission. Nothing in this section shall limit the commission's authority to require filing of data in any format by any regulated utility the commission deems necessary to accomplish its regulatory duties.

New Sec. 8. (a) The factors which shall be considered by the commission in making the determination of "prudence" or lack thereof in determining the reasonable value of electric generating property, as contemplated by this act shall include without limitation the following:

(1) A comparison of the existing rates of the utility with rates that would result if the entire cost of the facility were included in the rate base for that facility;

(2) a comparison of the rates of any other utility in the state which has no ownership interest in the facility under consideration with the rates that would result if the entire cost of the facility were included in the rate base;

(3) a comparison of the final cost of the facility under consideration to the final cost of other facilities constructed within a reasonable time before or after construction of the facility under consideration;

(4) a comparison of the original cost estimates made by the owners of the facility under consideration with the final cost of such facility;

(5) the ability of the owners of the facility under consideration to sell on the competitive wholesale or other market electrical power generated by such facility if the rates for such power were determined by inclusion of the entire cost of the facility in the rate base;

(6) a comparison of any overruns in the construction cost of the facility under consideration with any cost overruns of any other electric generating facility constructed within a reasonable time before or after construction of the facility under consideration;

(7) whether the utility having an ownership interest in the facility being considered has provided a method to ensure that the cost of any decommissioning, any waste disposal or any cost of clean-up of any incident in construction or operation of such facility is to be paid by the utility;

(8) inappropriate or poor management decisions in construction or operation of the facility being considered;

(9) whether inclusion of all or any part of the cost of construction of the facility under consideration, and the resulting rates of the utility therefrom, would have an adverse economic impact upon the people of Kansas;

(10) whether the utility acted in the general public interest in management decisions in the acquisition, construction or operation of the facility;

(11) whether the utility accepted risks in the construction of the facility which were inappropriate to the general public interest to Kansas;

(12) any other fact, factor or relationship which may indicate prudence or lack thereof as that term is commonly used.

(b) The portion of the cost of a plant or facility which exceeds 200% of the "original cost estimate" thereof shall be presumed to have been incurred due to a lack of prudence. The commission may include any or all of the portion of cost in excess of 200% of the "original cost estimate" if the commission finds by a preponderance of the evidence that such costs were prudently incurred. As used in this act "original cost estimate" means:

(1) For property of an electric utility which has been constructed without obtaining an advance permit under K.S.A. 66-1,159 *et seq.*, and amendments thereto, the "definitive estimate"; and

(2) for property of an electric utility which has been constructed after obtaining an advance permit under K.S.A. 66-1,159 *et seq.*, and amendments thereto, the cost estimate made by the utility in the process of obtaining the advance permit.

New Sec. 9. (a) If any portion of an electric generating facility is determined to be excess capacity and if the facility is a nuclear fission power plant, the state corporation commission shall determine whether there has been approved by the United States government through its authorized agency, a proven technology or means for the disposal of high-level nuclear waste which is available for use at or by the plant.

If the commission finds that no such technology for disposal exists, it shall be presumed that the costs of acquisition, construction or operation of the facility were incurred due to a lack of prudence and the commission shall not include such costs in the reasonable value of the public utility property.

(b) When used in this section, "technology or means for the disposal of high-level nuclear waste" means temporary on-site storage of high-level nuclear waste or an approved process for the retrieval of such waste.

New Sec. 10. If a fine or penalty for a safety or quality assurance violation is assessed by the nuclear regulatory commission against a public utility governed by the provisions of this act, it shall be presumed that the act or omission of the public utility causing the assessment of the fine or penalty occurred due to a lack of prudence and the commission may reduce the revenue requirements accordingly.

New Sec. 11. When a public utility sells electric power to other than its retail customers or disposes of, sells or retires from service any facility, the commission may evaluate the efficiency or prudence of such electric power sale or disposition, sale or retirement from service, and if it finds that any such action was inefficient or imprudent, or caused a reduction of electric power available to its retail customers or in electrical generating capacity, the commission may reduce the revenue requirement resulting therefrom.

New Sec. 12. The provisions of this act are declared to be severable, and if any section, sentence, clause or phrase of this act shall for any reason be held to be invalid or unconstitutional, the validity or application of the other provisions of the act shall not be affected, it being the intent of the legislature that the act shall stand notwithstanding the invalidity of any part.

Sec. 13. K.S.A. 66-128 is hereby repealed.

Sec. 14. This act shall take effect and be in force from and after its publication in the Kansas register.

I hereby certify that the above BILL originated in the HOUSE, and passed that body March 2, 1984.

HOUSE concurred in SENATE amendments March 30, 1984.

MIKE HAYDEN
Speaker of the House
GENEVA SEWARD
Chief Clerk of the House

Passed the SENATE as amended March 28, 1984.

ROSS O. DOYEN
President of the Senate.
LU KENNEY
Secretary of the Senate.

APPROVED April 13, 1984.

JOHN CARLIN
Governor.

STATE OF KANSAS

Office of Secretary of State

I, JACK H. BRIER, Secretary of State of the State of Kansas, do hereby certify that the above and foregoing is a correct copy of the original enrolled bill now on file in my office.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed my official seal, this 16th day of April, 1984.

(SEAL)

JACK H. BRIER
Secretary of State.

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APPENDIX C

INITIATIVE PETITION
AMENDMENT TO THE CONSTITUTION

ARTICLE XIII OF THE STATE CONSTITUTION IS HEREBY ADDED; AND ARTICLE VII, SECTION 24, IS AMENDED (NEW WORDS CAPITALIZED), AS FOLLOWS

ARTICLE XIII
PUBLIC UTILITIES

Section 1. No property or investment in property not actually used and useful in providing utility service shall be included in rate base or cost of service in fixing the rates of public utilities in this state.

"Used and useful," as used in this article, does not include, among other things, construction work in progress, utility property that was never placed in service, utility property not presently in use, for which the utility fails to show by clear and convincing evidence a definite, reasonable plan for cost-effective utility use, utility property which is used, but is not economically useful, utility property which is used, to the extent that the cost of the property exceeds the economic value of its usefulness, and utility property which is not necessary to providing adequate service at the lowest reasonable rates.

"Utility," as used in this article, means a public utility providing electric, gas, steam, or telephone service in this state, but unless otherwise stated does not include a municipally-owned utility or a rural electric cooperative.

"Ratemaking authority," as used in this article, means any person, body, or entity with power to fix utility rates, except the legislature to the extent it has delegated its ratemaking power.

Section 2. Utility rates shall not be based, directly or indirectly, in whole or in part, upon investment in or financing of utility property, or return on or recovery of the investment, unless the property is actually used and useful in providing utility service.

Section 3. Within nine months after the effective date of this article, the ratemaking authority shall, after evidentiary hearings, adjust each utility's rates to comply with sections 1 and 2, retroactive to the effective date of this article, and order prompt refunds with interest to the specific customers who, after the effective date of this article, paid more than the amount allowed by sections 1 and 2. Failure of the ratemaking authority to comply with this section shall constitute misfeasance and nonfeasance in office. The amount of any rate adjustment and refund shall be determined and ordered independently of any other change in the cost of service or rates.

Section 4. No utility property shall be included directly or indirectly in rate base or cost of service for ratemaking purposes at a value greater than fair value. Except for electric generating and associated transmission plant placed in service after January 1, 1984, "fair value" means prudent original cost less depreciation. For electric generating and associated transmission plant placed in service after January 1, 1984, "fair value" means the price a willing buyer would pay a willing seller under conditions of free and fully competitive markets in the sale of electricity and steam, and shall not exceed the reasonable alternative amount. The reasonable alternative amount is the amount which would cause rates to be fixed at the level that would be lawfully established if such plant had not been constructed, and the utility had made the least cost, reasonably required alternative arrangements to provide adequate and economical service. Such alternative arrangements shall include, but not be limited to, load management, conservation, improvement of the availability and capacity of existing generating equipment, strengthening and enlarging transmission and interconnection facilities with other utilities and power producers, and the purchase of firm or interruptible power from other utilities and power producers. In any rate-fixing proceeding, the burden shall be on the utility to establish by clear and convincing evidence the necessity and fair value of the utility property, and the reasonable alternative amount.

Section 5. Every utility, including a rural electric cooperative, shall provide adequate service at the lowest reasonable rates. If the utility is unable or unwilling to provide adequate service at the lowest reasonable rates, the ratemaking authority shall, after an evidentiary hearing, assign all or a portion of the utility's property and service territory located within the ratemaking authority's rate jurisdiction to another utility or utilities then in existence or to be created, including, but not limited to, rural electric cooperatives, municipally-owned utilities and investor-owned utilities, at a price no greater than the net depreciated prudent original cost of the property, as determined by the ratemaking authority. An assignment of property and service territory shall be effective only upon the concurrence of each acquiring utility, and subject to the provisions of article VII, sections 25 and 29, of this constitution. Service to territory assigned under this section shall not be restricted by any other law or article limiting the territory served or the quantity of utility services sold by a municipally-owned utility.

Section 6. An electric utility shall transport power at just and reasonable rates to and from any other electric utility in this state, unless doing so would make it impossible for the utility to serve its customers. "Utility" as used in this section includes, but is not limited to, a rural electric cooperative, a public power agency, a municipally-owned utility, and an investor-owned utility.

Section 7. If an electric utility sells power at wholesale, the ratemaking authority shall exclude from the rate base and cost of service of the utility's retail rates the utility's fully distributed cost of making such sale. The fully distributed cost includes, but is not limited to, the prorated portions of capacity costs, return on investment, and all other fixed and variable costs.

If the selling utility had electric generating or associated transmission plant under construction at the time the wholesale arrangement was first entered into, and such plant was placed in service after January 1, 1984, the cost to be excluded in fixing retail rates shall not be less than if the wholesale sale were made from such plant, including all of such plant's fully distributed costs.

Section 8. In any utility rate-fixing proceeding, the ratemaking authority, in determining a fair rate of return, shall not allow any increment for risk resulting from, or the need to attract capital for, construction work in progress, except to the extent that clear and convincing evidence demonstrates that the construction, or a portion of it, and its cost are necessary for providing adequate and economical service and that the construction is the least cost means of providing the service. A finding of necessity and least cost pursuant to this section shall not create a precedent or a presumption in any other proceeding, and such finding shall not create a precedent or a presumption that plant under construction, when completed, should be included in rate base or cost of service for rate-fixing purposes.

Section 9. In any rate-fixing proceeding, the ratemaking authority, in determining a fair rate of return, shall not allow any increment for risk resulting from amounts expended on construction that has been suspended or abandoned, on retired plant, or on plant that is no longer used and useful, except to the extent that the utility demonstrates by clear and convincing evidence that the expenditures and events that created the risk could not have been avoided or their effects mitigated by the exercise of prudent and efficient management.

Section 10. If any portion of this article or the application thereof to any person or circumstances shall be found to be invalid by a court, such invalidity shall not affect the remaining portions or applications of this article. This article is severable.

Article VII, Section 24. Subject to this constitution, any city or village may acquire, own or operate, within or without its corporate limits, public service facilities for supplying water, light, heat, power, sewage disposal and transportation to the municipality and the inhabitants thereof.

Any city or village may sell and deliver heat, power or light without its corporate limits in an amount not exceeding 25 percent of that furnished by it within the corporate limits, except as greater amounts may be permitted by law OR BY ARTICLE XIII OF THIS CONSTITUTION; may sell and deliver water and provide sewage disposal services outside of its corporate limits in such amount as may be determined by the legislative body of the city or village; and may operate transportation lines outside the municipality within such limits as may be prescribed by law.

PROVISIONS OF EXISTING CONSTITUTION ALTERED OR ABROGATED BY THIS AMENDMENT IF ADOPTED.

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COMMENTS OF ROBERT E. JOHNSTON, CHAIRMAN OF THE ARKANSAS PUBLIC SERVICE COMMISSION TO THE U. S. SENATE SUBCOMMITTEE ON ENERGY & WATER

1. One of the principal problems we are facing is the fact that the Federal Energy Regulatory Commission (FERC) is soft on utilities and is not doing its congressionally mandated duty of protecting wholesale electric customers from unreasonable utility rates and practices. Various sources as diverse as Forbes, Newsday, Barrons, Merrill Lynch, Solomon Brothers and the National Regulatory Research Institute at Ohio State University have concluded that the FERC basically is lenient on utilities and hard on ratepayers when compared with the efforts of state regulatory commissions.

The FERC has all but ignored the overall purpose and intent of the Public Utilities Act of 1935, incorporated as the Federal Power Act (FPA) and the Public Utilities Holding Company Act (PUHCA). Apparently they have forgotten the evils which this legislation was designed to prevent.

The FERC clearly gives little credibility to the words of former President Franklin D. Roosevelt. President Roosevelt comprehended the clear need for consumer-minded utility regulators. In his first Presidential campaign in 1932, F.D.R. laid down his philosophy of utility regulation:

> The [utility] commission is not a mere judicial body to act solely as umpire between complaining consumer or the complaining investor on the one hand, and the great public utility system on the other hand. . . . As the agent of the legislature, the . . . Commission had, and has, a definitely delegated authority and duty to act as the agent of the public themselves; that it is not a mere arbitrator as between the people and the public utilities, but was created for the purpose of seeing that the public utilities do two things: First, give adequate service; second, charge

> reasonable rates; that, in performing this function, it must act as agent of the public, upon its own initiative as well as upon petition, to investigate the acts of public utilities relative to service and rates, and to enforce adequate service and reasonable rates.
>
> The regulating commission, my friends, must be a tribune of the people, putting its . . . resources into the breach for the purpose of getting the facts and doing justice to both the consumers and investors in public utilities. This means, when that duty is properly exercised, positive and active protection of the people against private greed will result.

A member of this august body, two decades ago, said: "President Roosevelt's words ring as true today as when he uttered them. His pronouncement should be posted in the office of every regulatory commissioner, in the State House, and in the White House." I agree totally. [Senator Lee Metcalf and Vic Reinmeer OVERCHARGE p. 2i (1967).]

2. One of the major problems which existed in 1935 as well as today was the ability of multi-state utility holding companies to financially "milk" their local subsidiary electric companies to the detriment of the retail consumers--in this instance the retail consumers of Arkansas and Mississippi, two of the poorest states in the nation. Then as well as now, utility holding companies, such as Middle South Utilities, often charged their local subsidiary electric companies unreasonable fees through service contracts and took out more dividends than the profits of the local companies. I suggest to you that it is very difficult for $300,000 a year utility executives and well heeled utility lobbyists (who operate out of fancy hotel suites and air-conditioned office buildings often far distant from the sweating farmers, workers and senior citizens who are having to scrape to pay for minimal air conditioning) to understand the plight of the poor.

These and other utility holding company ills--often a stupefying misuse of corporate structure--were and remain a national disgrace. They were NOT CURED by the PUHCA and the FPA--due to the continued unwillingness of the Securities and Exchange Commission (SEC) and the FERC to assume and execute their sworn duty and responsibility.

There has been and continues to exist a serious regulatory gap caused by the abdication by the SEC of its duty to exercise meaningful oversight over utility holding companies, and by the birth (and approval by the SEC) of "Separate Generating Subsidiaries" such as Middle South Energy (MSE) which is a subsidiary of Middle South Utilities. MSE is no more than a paper corporation, a corporate shell with no officers or offices separate from its parent. MSE, with $4 billion in "assets" and liabilities, left both the construction and operation of the Grand Gulf nuclear plant (400% over-budget and 7 years behind-schedule) solely to one of its smaller operating companies, Mississippi Power & Light (MP&L). MP&L, which originally undertook the construction of Grand Gulf (then the nation's largest and most complicated nuclear plant) was and is a small operating company, unsophisticated and unexperienced in building nuclear plants. It had never before built a nuclear plant let along one as large and complex as Grand Gulf. MP&L ultimately abandoned the construction of Grand Gulf because it didn't have the necessary financial resources to complete the project and also because it simply didn't need it.

Add to that the cavalier attitude of the SEC, MSE, and the FERC (which by the way changed its policy in midstream with respect to "Prudence of the PURCHASER") and you have a system which works a severe disadvantage on those "served" by utility holding companies, i.e. the local ratepayers. Such a system effectively reduces the ratepayers to 19th century indentured servants with little choice but to pay what they are commanded to pay. The landmark utility legislation of 1935 was intended to free the ratepayers from the unfair and highhanded tactics of powerful monopolistic utility holding companies.

For several years the FERC has said that it doesn't look at the prudence of the PURCHASER--but leaves that responsibility to the state regulatory commissions. But then, suddenly in 1984 and 1985 with respect to two multi-billion dollar, multi-state holding companies, American Electric and Middle South Utilities, the FERC changed their tune. Changing horses in midstream the FERC lived up to the observations of _Newsday_, _Barrons_, _Forbes_, Ohio State, etc. that the FERC is essentially pro-utility and anti-consumer. The FERC _now_ adds to their earlier policy pronouncement that . . . _EXCEPT_ for the citizens in states served by holding companies; _there_, _we_, FERC will also determine whether it is prudent for an operating company subsidiary to enter into agreements to pay for a nuclear plant even if it is never built and never produces power. In fact, it may be, that by being part of a utility holding company system, that state commissions and their ratepayers now have _no_ rights or protections beyond what the FERC gives them, and the FERC has clearly demonstrated that it is not going to be very tough on utility holding companies. As an example the FERC has recently given them a right to earn 16 or 17 percent profits (return on equity). Once a state becomes entangled with a utility holding company, it is in its clutches for better or worse. That this FERC philosophy flies so patently in the face of the spirit, intent and even specifics of the PUHCA does not seem to give FERC any pause. The PUHCA was created to extend to citizens, served by operating companies owned by utility holding companies, the same first class STATE protections, buttressed by the SEC acting in concert, in joint or dual regulation with the states, as all other consumers enjoyed. That protection has now been all but swept away by the actions of the FERC, the SEC and the powerful holding companies of this country.

3. Before I turn to my prediction and warning that this danger is not unique to the Middle South states or the part of Middle America "served" by American Electric (or even to those areas not now served by holding companies) let me alert you to another danger contained in the regulatory philosoply (or lack thereof) of the FERC regarding its approach to the prudency of the SELLER.

The FERC has never disallowed even as much as $10 million in imprudently incurred construction costs of a generating plant. That's not only not surprising, but that's probably the most convincing, "prima facie" evidence that what Newsday, Barrons, the National Regulatory Research Institute, etc. have concluded is in fact true--that the FERC is not the protector of consumer interests that state regulatory commissions are.

In the Grand Gulf case we were faced with a $3.5 BILLION nuclear generating plant (which was not and is not now needed by the ratepayers in the four states for which it was built) which was 400% over-budget and years behind schedule. Yet, neither the FERC staff, nor the FERC Administrative Law Judges, nor the FERC Commissioners themselves ever raised even the possibility of any imprudence in the construction of Grand Gulf by the seller, Middle South Energy. The FERC should have at least considered and investigated the prudency of MSE, i.e., (1) in the decision to begin construction of a highly sophisticated and extremely complicated nuclear plant in one of the poorest, most rural states in the nation; (2) then continuing the construction of Grand Gulf as demand for its electricity plummeted from 7% growth projections to 0% growth projections and despite radical changes in national policy; and (3) continuing to spend over $3,500,000,000 to complete it.

There have been numerous examples over the last three years (the period straddling the FERC's arbitrary and unfair assignment of $1 billion annually in Grand Gulf costs to the ratepayers in Arkansas, Mississippi, Louisiana and Missouri of state commissions examining the prudency of the seller/builder of billion-dollar-plus generating plants and the disallowance of hundreds of millions of dollars of what the state Commission determined to be imprudently incurred costs. But NOT AT FERC, that's not in their game plan, not in their budget, not within their goals and purposes. The FERC should themselves act responsibly and protect the ratepayers from such imprudent costs. But they haven't.

In our part of the country when a man gives his word it is worth something, but Middle South didn't keep their word. They didn't even try to keep their word. They essentially sold Arkansas out in order to benefit one of their other states. Remember, that Arkansas had previously negotiated and entered into a lawful contract which relieved it of any Grand Gulf obligation.

4. One claim you have heard is that this proposed legislation is "unconstitutional" because of its "retroactive aspects." This Congress each session passes bills which have retroactive aspects--but prospective

from the date the bill was introduced. The 1986 tax reform bill is one example; the tax measures of 1981 and 1982 are other examples. Those potentially affected by the legislation which you now have before you have been on notice from the date of its introduction.

Middle South as well as other utilities took risky postions based on what they thought they could get away with. Middle South could have voluntarily sought the same permission required in this proposed bill from the state commissions, instead they preferred to take the risk, to gamble that they could get someone to pay for Grand Gulf. For them to now claim that "retroactivity is unfair," or that requiring "prior permission" is unconstitutional, when they knew that was an option, is patently unfair.

Furthermore, both Middle South and the FERC have engaged in retroactive changes themselves, i.e.:

A. Middle South officials testified before the Arkansas Public Service Commission that permission would be sought from the FERC for an allocation of Grand Gulf based on an operating companies' need, which would have resulted in a 0% allocation request for Arkansas; then without any additional notification to Arkansas authorities Middle South companies signed various financial agreements with banks for a different allocation for Arkansas.

Middle South signed an agreement providing for a 0% allocation to Arkansas and then without even notification to state authorities changed their position and supported (and continues to support) an allocation of 36% of Grand Gulf to Arkansas.

B. The FERC adopted policies in 1974 of "no utility system cost averaging" and in 1981-84 regarding the prudence of a purchaser as being in the purview of state commissions and then in 1985 suddenly wiped out a decade of precedent and altered both policies. But even worse the FERC had the temerity to say in 1983, that "the prudence of a sales agreement should be judged on the circumstances prevailing at the time such a contract is entered into . . . we suggest that evaluation of the prudence of a 1979 power contract on the basis of 1982 demand forecasts is neither fair or appropriate . . . (ratepayers and utilities) are entitled to rely on . . . contractual commitments to purchase capacity . . . ." (23 FERC 61,006 at 61,019; 1983).

Then in the Middle South case, the FERC relied on 1973, 1980 and 1981 agreements when it served their purposes and ignored 1982 agreements while looking at the conditions and costs since 1982.

The 1982 Middle South Unit Power Sales Agreement was based on conditions existing and agreements entered into in the 1979-80 time frame, but the FERC (and later Middle South) didn't examine the "circumstances prevailing at the time such a contract is entered into" as they said in 1983 ought to be done . . . instead they now looked at conditions which developed after 1982. They also conveniently overlooked the supply side of the Demand/Supply Equation; overlooked the four coal plants that Arkansas had built during the time Middle South had operated under the "Participation Unit--You Don't Have to Pay for Grand Gulf If You Have No Need for Power Concept."

Thus Middle South and apparently the FERC are now saying, "you can't change the rules in midstream, but we can." I think they protest too much.

5. A number of states and significant numbers of ratepayers are presently served by utility holding companies, including states represented by members of this subcommittee and even more of the full committee. This problem will be knocking at your door, if not next week or next month, then next year or the next: Your utility holding company may well be forming a "Separate Generating Subsidiary" and slipping under FERC jurisdiction in order to achieve higher profits and freedom from scrutiny on prudence, both of construction and of purchase.

And, many of your electric utilities which are NOT now members of holding companies are today, looking at the considerable advantages of becoming holding companies in an era of "DEREGULATED, Look the Other Way Regulation" by the SEC and the FERC.

Rest assured that many electric utilities are presently considering forming holding companies. They are sniffing the winds of change and detecting the signals that they can effectively evade state protection of ratepayers by so doing. And when this comes to pass and electric rates in your states go up--and it will happen unless legislation like this is passed--ratepayers in your states, your constituents, your voters are going to be calling you--asking you what you did to prevent this misuse--this gross abuse of the nation's corporate and utility regulatory scheme. If they discover that you had this opportunity to do something and didn't do anything, they might just perchance blame you.

Instead of having to say you did nothing in 1986, you can instead say that you voted for this corrective legislation and thus avoided the problem.

In closing, let me again quote President Roosevelt:

> The problem is not confined to the State alone. It is nationwide. As a result of a long course of judicial decisions and of newly invented methods of financing, the householders and business-men of the Nation, in a great many cases, must now pay exorbitant rates, measured not in terms of reasonableness for legitimate investors but rather in terms of speculative profit.
>
> We can, of course, have no objection to a reasonable return for the real investor in stocks of utility companies; indeed we should actually do everything possible to safeguard such reasonable return for him. The difficulty is rather with those who seek unreasonably to inflate profits and promote speculative trading by so pyramiding capital structures in holding companies and otherwise that profits are made on stock which is not always represented by actual investment.
>
> The housewives of many parts of the State look to us for relief from rates so high as to deprive them of the advantages of modern science to release them from household drudgery. . . .
>
> This ever-growing public demand for more effective regulation should be met promptly. It would be a fine thing if you and I, serving a common master--the people . . . would unite in this common purpose of bringing into the homes and stores and factories of our State, these modern utilities at a cost reasonably consistent with a fair return to the legitimate investment in these corporations. . . .
>
> (F.D.R. Annual Message to Legislature, 1931, p. 107).

* * *

Hopefully your committee will report the bill out favorably.

Yours sincerely,

Robert E. Johnston, Chairman
Arkansas Public Service Commission

Senator **Bumpers**. Governor Clinton, thank you very much for your statement, and a powerful statement it is.

Let me say that I cannot evaluate right now what our chances are, but I will say this. With the arrogance that has been demonstrated by FERC and what I think will be a growing sentiment for this legislation, there is no pride of authorship. Perhaps a couple of changes need to be made in this bill. Maybe it ought to be broadened to include utilities other than holding companies.

For somebody to just literally take away one of the most basic, traditional, historical States' rights, and that is to regulate the monopolies that they grant—it is the State of Arkansas that has granted the monopoly and somebody else who is doing the regulating. That is an inconsistency in the minds of all thoughtful people who are interested in democratic government.

So my tenacity, I hope, will not sag during this. If we lose this year, we will win next year. If we lose next year, we will win the next year. This has to be addressed, and I believe there is an increasing awareness among my colleagues, incidentally most of whom had to go just now to vote on the cigarette tax and hopefully will return very shortly. They did not leave because you were boring, Bill. They left because they had to go vote.

Let me return to a couple of points. No. 1, so far as power pooling is concerned, I said in my opening statement if people say this will dampen power pooling, in one sense I say that is great. That is fine if power pooling means that FERC is going to have the same authority over power pooling consortiums that they have over utility holding companies.

Morgan Stanley may have somebody to testify that this legislation would dampen the financial community's enthusiasm for financing powerplants. In my opinion, the bill would be the greatest thing that ever happened to the financial community, because they would have the certainty that utilities could recover the costs of State-approved plants—I promise you, if Middle South had this to do over again, they would have taken an entirely different tact.

Governor **Clinton**. Of course. For one thing, it will not dampen power pooling. What it will do will discourage further plant building that is unnecessary.

Senator **Bumpers**. Absolutely.

Governor **Clinton**. It will encourage people to cooperate, but it will be voluntary cooperation. You will not have someone shoving it down your throat, paying for a powerplant you do not need. Instead, you will have economic incentives for maximum regional power planning where people will agree on the front end to pay for what they need, and then they will be getting what they need.

Senator **Bumpers**. You know, the fact that they had to go to a paper subsidiary to finance this thing should have been a red flag to everybody. If they could not finance it through one of their subsidiaries, that should have been a red flag that this power was not needed. Instead, they went ahead and Mississippi could not do it, and so they said, well, we will just bring everybody into it. So, as you say, in the future they are going to make sure that the power is needed before they get into this.

One final question, Governor. As you know, this bill has a retroactivity feature in it, and I would be interested in your comments because that is one of the things that Middle South will argue is unconstitutional about it.

Governor CLINTON. Well, I think there are others who are better qualified than I to comment on the unconstitutionality of it. You do pass bills up here all the time which have some retroactive effect, as you know.

I would just like to say that I think that the FERC decision was retroactive. What the FERC said to us was here is this agreement you have that says you owe nothing. We are tearing it up into little shreds, and you were fools to ever think that this agreement meant anything because, really, Middle South does not exist as a set of independent utilities. It is all just one utility, so it cannot make an agreement with itself. Too bad if you relied on it. Too bad if you relied on what the president of the corporation said when he raised his hand and swore to tell the truth and said you would not have to pay for it if you did not need it. We do not care. We are retroactively sticking you with something you never agreed to pay for that you even had a legal, what we thought was a legally enforceable contract, saying we did not.

So I think that you ought to ask them, when they say you should not be retroactive, how clean their hands are, those people that came in and hustled up this retroactive decision by FERC, because it certainly was retroactive.

Senator BUMPERS. Just to make a last observation, and you can comment on it, it seems to me that if this legislation is passed, it will also redress one of the most painful parts of this, and that is that Middle South probably misrepresented this whole thing almost at every step of the way, to you in 1977, to the Mississippi Public Service Commission when the certificate was sought.

Under this bill they have to come in and make certain representations in the beginning, and after the generating capacity is built and FERC sets a rate, the utilities have to come back and show that those representations were correct. And if they were wrong and if they were misrepresentations, the Arkansas Public Service Commission, for example, would still have the right at that point to redress the problems of those misrepresentations.

Governor CLINTON. That is right. The practical impact of your bill would be that in all future plant decisions, all the States affected will have to sign off at the State PSC level on the front end, just like they today for plants built in their own States.

That is the practical effect of your bill and that is exactly what the law ought to be, because to be fair in this case, as you know, the managers of the Arkansas utility, AP&L, made a good faith effort to get what they thought was a binding agreement, a legally binding agreement, giving Arkansas a zero allocation.

But it was not an agreement subject to a hearing before the Public Service Commission because they did not have the jurisdiction to do it.

So if you change the law in this way, we would be finally protected, and it will be good for the utilities. They will be better off with this law. Middle South says we are going to need eight more power plants in the next few years. How are they going to build them? If they get away with this, they may build them under FERC jurisdiction, not the State's jurisdiction. Poor Mississippi—forget Arkansas—Mississippi has got 100 percent reserve capacity with a 10-percent unemployment rate and the lowest per capita income in the country. How are they supposed to shoulder this load? And, believe me, they were never told—never, never told they would have to take 33 percent of that powerplant.

Senator **Bumpers**. Senator Pryor, do you have any questions?

Senator **Pryor**. I just apologize, Senator Bumpers——

Senator **Bumpers**. Do we have a cigarette tax or not?

Senator **Pryor**. Well, we just raised it 8 cents. That is downstairs. It was either raising the telephone tax or the cigarette.

Governor **Clinton**. You made the right decision, Senator. [Laughter.]

Senator **Bumpers**. Sorry I asked.

Senator **Pryor**. That is why I had to leave, Governor. I am running back and forth on votes. I do apologize. We all appreciate your being here. We also all appreciate what you have done over these past 2 years in this Grand Gulf fiasco.

I am sorry, once again, that I had to leave during your testimony.

Senator **Bumpers**. Governor, thank you very much.

Mr. Chairman, thank you for coming along too.

Our first panel is the Honorable William F. Martin, Deputy Secretary, Department of Energy, accompanied by Mr. J. Steven Herod, Director of Coal and Electricity Policy, Department of Energy.

The next witness is Mr. Chris Warner, Associate General Counsel, Legislation, Regulation, and Congressional Affairs, Federal Energy Regulatory Commission, and Ms. Cynthia A. Marlette, staff attorney, Office of General Counsel with FERC.

Welcome. And, Mr. Martin, if you would, thank you for coming over, and would you please proceed?

STATEMENT OF WILLIAM F. MARTIN, DEPUTY SECRETARY, DEPARTMENT OF ENERGY, ACCOMPANIED BY J. STEVEN HEROD, DIRECTOR OF COAL AND ELECTRICITY POLICY, DEPARTMENT OF ENERGY

Mr. **Martin**. Thank you, Mr. Chairman. It is a pleasure to be here, side by side with FERC today on this issue of importance to Arkansas, and indeed to the whole country.

Senator, I live in Oklahoma and I know this case has raised a lot of concern that is even across the border somewhat, and I am well aware and have sympathy for the situation which the ratepayers in Arkansas face. Indeed, I think we share the same objective.

Senator **Bingaman**. Where do you come from in Oklahoma, Mr. Martin?

Mr. **Martin**. Tulsa.

I think we share the same objective, Senator, to improve the rate regulatory practices and provide consumers with reasonably stable electricity prices over the long term.

DOE is concerned that the Nation be assured of adequate and efficient electricity within the context of the increasingly regional nature of our electric power industry. In addition to looking at the issue of price stability, which we think is an important factor, we also have to look at the issue of long-term power adequacy and the efficiency of regional operations.

In evaluating these three criteria, we believe that S. 1149 would not indeed improve the regulatory process and would not be of beneficial reform for the consumer in any particular State or region.

We believe there are three concerns. First, S. 1149 threatens the increasingly regional nature of the electric power industry and the efficiency gains available through power pooling and joint ventures in new facilities.

Second, the bill exposes a utility building a new facility under FERC's regulatory oversight to large potentially uncompensated financial risks.

And, third, by creating significant uncompensated financial risks to utilities involved in interstate power trade, S. 1149 would threaten the efficiency and sufficiency of future electric power supplies.

The bill focuses primarily on State versus Federal regulation, but we indeed think that there is another basic problem; basically the precipitous increase in rates that can occur when major new power facilities like Grand Gulf are put into service and into the rate base.

We would note that potential rate shock problems have been mitigated to an extent in Arkansas by the settlement agreed to by Arkansas regulators and Arkansas Power & Light by which rate increases attributable to Grand Gulf I unit will be phased in and Middle South Energy will be required to take back a portion of APL's allocation.

We also note that the FERC has shown its awareness of the need to move beyond the traditional regulatory practices which contribute to the rate shock problem.

In its recent notice of inquiry, the FERC sought comments specifically on whether market-based pricing of wholesale electricity by which rates for new plants would be lower in earlier years of operation and higher in later years would contribute to greater economic efficiency.

Thank you, Mr. Chairman. That concludes my statement.

[The prepared statement of Mr. Martin follows:]

PREPARED STATEMENT OF WILLIAM F. MARTIN, DEPUTY SECRETARY, DEPARTMENT OF ENERGY

Thank you, Mr. Chairman, and Members of the Subcommittee, for the opportunity to appear before you today to discuss S. 1149 and the impacts it would have on the electric power industry in this country. This legislation and the circumstances which led to it, raise many difficult and complex issues which bear directly on the long term adequacy and efficiency of the electric power system in the Southwest and the Nation as a whole. We are sympathetic with the concerns of the people of Arkansas over the rate increases they are being asked to shoulder, and we recognize the importance as do the sponsors of S. 1149, of improving rate regulatory practices in order to provide consumers with reasonably stable electricity prices so that situations like this can be avoided in the future.

While stability in electric power rates is critically important to consumers, the assurance of adequate and efficient supplies in the future is also critical. At the levels of demand growth currently being projected by the Department and others, as much as 100 to 300 gigawatts of new electric generating capacity would be required by the end of this century to meet this growth in demand and to replace physically and economically obsolete facilities -- that is equivalent to 100 to 300 large new power plants above and beyond those currently under construction. There is, of course, much uncertainty in projections such as these, but the inescapable conclusion is that there is the very likely prospect that the electric power industry will be called upon to make substantial new capital investment in order to assure adequate supplies over the remainder of this century and beyond.

In addition to stable prices and adequate long term supplies, it is also important that consumers are given the benefit of efficient operations of electric power systems. Increasingly the pursuit of efficient operations has led this industry toward a more regional structure.

The basic question we must ask about any proposed reform in electric power is whether it benefits the consumer in all of these dimensions; price stability, long term power adequacy and efficient regional operations. Does the reform offer the consumer stable prices while at the same time providing assurances of adequate and efficient supplies and efficient operations of the existing system?

When evaluating S. 1149 in all of these dimensions, we conclude that it would not improve the regulatory process and would not be a beneficial reform for the consumer in any particular state or region.

For several reasons the Administration must oppose S. 1149:

- S. 1149 would work against the increasingly regional nature of the electric power industry, and would threaten the efficiency gains available to the industry through power pooling and joint ventures on new capital facilities.

- Under S. 1149 a utility which constructed a new facility subject to FERC's regulatory oversight may not be able to fully recover capital costs due to inconsistent and uncoordinated regulatory decisions. Such a circumstance would pose large uncompensated financial risks to utilities undertaking future capital programs.

- By creating significant uncompensated risks to utilities involved in interstate electric power trade, S. 1149 would inhibit new utility investments and threaten the efficiency and sufficiency of future electric power supply.

S. 1149 clearly works against the efficiency benefits from expanding regional power operations. Electricity consumers have benefitted substantially from the increasing trade between power companies (coordination trade) which lowers power costs. Today roughly 50% of all electricity sold at retail has previously been sold in wholesale markets. This is up from 25% in the early 1960s. Power pooling arrangements which have grown at rapid rate in the past two decades are saving electricity consumers hundreds of millions of dollars every year. For example, the PJM power pool which serves the District of Columbia as well as the states of Pennsylvania, New Jersey, Delaware, and Maryland estimates that the operations of this pool saved consumers in this region $393 million dollars in 1985 alone. Additionally, the use of joint ventures on new projects has expanded rapidly to take advantage of scale economics and to diversify risk among participants. These rapid changes have made electric power markets increasingly efficient and increasingly inter-state in nature.

S. 1149 would exacerbate concerns about long term sufficiency of electric power in the Southwest and nationwide. This legislation is premised on the concern that utilities will seek to build new facilities without appropriate authorization from affected states. In our view a more serious concern is that utilities in the future will be unwilling to initiate new construction programs on a timely basis in order to meet the future power needs of an expanding economy. Although consumers have absorbed much of the costs of facilities built in the past decade, investors have absorbed a substantial portion of these costs as well. From the investors' point of view, capital investment in electric power facilities has become a considerably more risky undertaking than before. From the point of view of national energy policy, the long term implication is that the uncompensated regulatory risk associated with S. 1149 could further undermine the electric utility industry's incentives to make the capital investments which will be needed to ensure adequate supplies at a reasonable cost.

We sympathize with the rate payers in Arkansas and throughout the Middle South service territory who are shouldering the rate increases associated with bringing the Grand Gulf plant into service. Senators Bumpers and Pryor have cited many cases of the hardships induced by these higher rates. We are learning from cases all across America that the sharp rate hikes which can result when some new power plants first come into service can be destabilizing and financially burdensome. They are harmful to individuals trying to maintain household budgets and they are harmful to commercial enterprises and industry trying to remain viable in increasingly competitive world markets.

We would note that Arkansas regulators and Arkansas Power and Light (AP&L) have reached a settlement which will mitigate rate increases by phasing-in the Grand Gulf allocation and by requiring a portion of AP&L's allocation to be "taken back" by Middle South Energy and not charged to Arkansas consumers. As a result, the maximum rate increase for AP&L attributable to Grand Gulf 1 has been estimated at 16% in 1991, with smaller increases before and after that date. We believe this settlement will be helpful for Arkansas households and commercial enterprises that otherwise might be faced with significant rate shock.

S. 1149 focuses only on the issue of Federal versus state regulation. It ignores the root cause of the problem Grand Gulf and many plants like it do pose to electricity consumers. This problem is the precipitous increase in rates that can occur when major new power facilities like Grand Gulf are put into service and into the rate base. The combination of several factors, including higher than expected plant costs and the front end loading of cost recovery that is inherent with traditional rate regulatory practices at both the state and Federal level, has created serious problems with rate stability. This phenomenon has come to be known as "rate shock." Whether we choose to put the burden of "rate shock" on consumers in the state of Arkansas or Mississippi or any other state, we still have a serious problem of rate instability associated with putting new plants into service. It is a serious problem that has surfaced all over this country, regardless of whether the plant involved is regulated by the state or the Federal government.

The FERC has shown its awareness of the increasing importance and complexity of its responsibilities and of the need to move beyond the traditional regulatory practices which contribute to the "rate shock" problem. The best evidence of this is the Notice of Inquiry it conducted on the regulation of electricity sales-for-resale and transmission service. This inquiry sought input specifically on whether market-based pricing of such goods and services would contribute to greater economic efficiency. The FERC has also conducted an experiment in the pricing of bulk power to determine whether substantially curtailing regulation of coordination markets could result in reduced prices and increased economic efficiency. Through initiatives such as these, the FERC has shown good initiative in seeking to improve its regulatory practices by evaluating and pursuing innovative and more market-like methods of setting prices for a wider range of electricity services.

To summarize, Mr. Chairman, I conclude that the short term benefits that S. 1149 would offer to consumers in Arkansas are more than offset by the potential long term losses the bill would create for consumers in Arkansas and throughout the nation. Our Nation's electric power system is an increasingly important part of our Nation's energy economy. In seeking reforms to improve the performance of this system for consumers today and in the future, we must avoid expedient solutions which offer benefits to a limited number of people for a limited period of time and instead look for opportunities that build toward a stronger and more efficient system today and into the future.

This concludes my statement, Mr. Chairman. I would be pleased to answer any questions you or Members of the Subcommittee may have.

Senator **Bumpers**. Thank you very much.

Mr. Warner, thank you for coming and please proceed.

STATEMENT OF CHRIS WARNER, ASSOCIATE GENERAL COUNSEL, LEGISLATION, REGULATION, AND CONGRESSIONAL AFFAIRS, FEDERAL ENERGY REGULATORY COMMISSION, ACCOMPANIED BY CYNTHIA A. MARLETTE, STAFF ATTORNEY, OFFICE OF THE GENERAL COUNSEL, FEDERAL ENERGY REGULATORY COMMISSION

Mr. **Warner**. Thank you, Mr. Chairman. I, too, appreciate the opportunity to testify before you today on S. 1149, legislation introduced by yourself and Senator Pryor.

I ask unanimous consent that a letter dated June 20, 1986, to Chairman McClure, submitting the Commission staff comments on S. 1149, be included in the record.

Senator **Bumpers**. Without objection, so ordered.[2]

Mr. **Warner**. Our staff comments are technical in nature and do not necessarily represent the views of the Commission, the Acting Chairman, or any Commissioner. We believe that to the extent certain issues are addressed today that touch on matters pending before the Commission, I will attempt to be responsive to the committee, but of course will also attempt not to directly touch on the merits of these pending matters.

Mr. Chairman, in reviewing S. 1149, the Commission staff recognizes that the Commission's jurisdiction is bound by the statutory authority delegated to it by Congress and that Congress always retains the discretion to modify that legislative grant of authority consistent with the U.S. Constitution.

To the extent Congress chooses to modify the Commission's jurisdiction under the Federal Power Act, for example, the Commission is obligated to exercise that jurisdiction consistent with the new boundaries drawn by Congress.

We also recognize, Mr. Chairman, that under section 308 of the Federal Power Act, any interested State or State Utility Commission may intervene in any FERC proceeding. In such a proceeding, State Commissions can, and often do, actively participate in representing the views of their retail ratepayers and also in raising issues that bear on the Commission's exercise of its own jurisdiction.

Therefore, the Commission, in exercising its jurisdiction, for example under sections 205 and 206 of the Federal Power Act, to review the justness, reasonableness and nondiscriminatory nature of electric rates or power pool agreements, is obligated to consider the comments and views presented by the State commissions.

S. 1149 would redraw these current jurisdictional boundaries under the Federal Power Act so as to divest the Commission of a major part of its jurisdiction over electric sales for resale in interstate commerce, specifically those involving holding company power pools.

The bill would permit individual States to override individual decisions affecting interstate commerce where those decisions involve certain transactions among affiliates of a utility holding company system.

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[2] The letter appears following Mr. Warner's prepared remarks.

In the opinion of the Commission staff, S. 1149 would sanction potentially inconsistent and conflicting ratemaking decisions by more than one State commission regulating a single utility and could possibly interfere with power pooling and the efficiencies associated with power pooling in this country.

Under the Federal Power Act, the Commission does have the authority to review and in appropriate circumstances to modify bulk power arrangements among interstate electric utilities. Sections 205 and 206 of the Federal Power Act require that jurisdictional rates be just and reasonable, and section 206 itself directs the Commission to modify any contract affecting jurisdictional rates if it finds after hearing that such contract is unjust, unreasonable, unduly discriminatory or preferential.

Many power pools operate on the premise that in order to achieve greater economies and reliability, the pool members will operate on a coordinated basis and from time to time the companies will build a generating unit larger than necessary to meet its immediate needs.

The company constructing the unit will share the output of the unit with other pool members until such time as it can absorb the unit's total output to meet the needs of its customers.

S. 1149 would allow certain State commissions to disregard the allocation of costs established by the Commission under such power pool agreements. Further, the bill would allow State commissions to disregard the actual rate level set by the Commission, even though they may agree with the actual allocation of cost.

Another possible effect of S. 1149 would be to discourage coordinated and integrated planning by affiliated members of power pools and the economies achieved through such planning.

In the opinion of Commission staff, if enacted, S. 1149 may be challenged on the grounds that it violates the bright line separation of Federal and State jurisdiction over electric rates intended by the Federal Power Act.

Recently, as previous witnesses have mentioned, in the 1986 *Nantahala* case, the Supreme Court has upheld the Federal Energy Regulatory Commission's preemptive authority under the Federal Power Act to alter power allocations agreed upon by interstate affiliates of an electric utility. In addition, the court held that the Commission's preemptive authority under the filed rate doctrine is not limited to rates *per se*, but also applies to the Commission's allocation of power between interstate affiliates when that allocation directly affects jurisdictional wholesale rates.

The Commission's allocation determination reflected in the wholesale utility's filed rate must be respected by the State commission regulating applicable retail rates, according to the Supreme Court.

Mr. Chairman, the issues raised by S. 1149 certainly are more broad than the Federal Power Act and the Commission's jurisdiction as delegated by Congress. This legislation involves an issue that is national in scope, involving competing State interests under our system of Federalism. Our staff comments on S. 1149 are technical in nature, but we recognize the importance of the overall issues not only to electric ratepayers in Arkansas, but also to electric ratepayers across the country.

Thank you and I would be happy to answer any questions you might have.

[The letter submitted by Mr. Warner follows:]

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

June 20, 1986

Honorable James A. McClure
Chairman, Committee on Energy
and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of April 29, 1986, to Acting Chairman Anthony G. Sousa, requesting a study and report on S. 1149, which would amend the Federal Power Act. The Federal Energy Regulatory Commission (Commission) staff has reviewed the proposed bill and would like to submit the following comments.

S. 1149 would allow state commissions, in setting retail rates for a utility, to disregard rates established by the Commission for transactions: (1) which involve a jurisdictional transmission or sale of electric energy among affiliates of a public utility holding company, and (2) are based in whole or in part on an allocation of electric energy or costs of production of electric energy from a generating unit, and (3) in which the affiliate receiving or purchasing the energy or being allocated production costs is subject to the jurisdiction of a state commission which had not approved the construction of the generating unit.

Under the Federal Power Act, the Commission has authority to review and, in appropriate circumstances, to modify bulk power arrangements among interstate electric utilities. Section 201 of the Act gives the Commission jurisdiction over the transmission of electric energy in interstate commerce and the sale of electric energy at wholesale in interstate commerce. Jurisdiction over retail transactions is reserved to the states. Sections 205 and 206 of the Act require that jurisdictional rates be just and reasonable, and section 206 directs the Commission to modify any contract affecting jurisdictional rates if it finds, after hearing, that such contract is unjust, unreasonable, unduly discriminatory or preferential. The consideration of the costs of constructing and operating necessary generating facilities are an integral part of the wholesale rate setting process.

A number of state courts have held, under what has become known as the *Narragansett* doctrine, that once the Commission, in a wholesale rate proceeding, allows a utility to charge a rate reflecting certain costs determined to be just and reasonable, a state commission having regulatory jurisdiction over the utility is required by the Supremacy Clause of the United States Constitution to allow the utility to recover the Commission-approved costs in its retail rates. 1/ The Supreme Court of the United States recently upheld this doctrine, stating that "[w]hen FERC sets a rate between a seller of power and a wholesaler-as-buyer, a State may not exercise its undoubted jurisdiction over retail rates to prevent the wholesaler-as-seller from recovering the costs of paying the FERC-approved rate." *Nantahala Power & Light Co., et al. v. Thornburg*, No. 85-568, slip op. at 16-17 (U.S. June 17, 1986). Thus, while the Commission does not establish retail rates, it does establish the justness and reasonabless of certain costs which a utility might seek to recover as purchased power costs in a state retail ratemaking proceeding. States and state commissions, however, may protect their interests by intervening in Commission proceedings to increase rates under section 205, by filing a complaint under section 206 or 306, and by seeking court review of Commission orders pursuant to section 313 of the Act.

1/ Narragansett Electric Co. v. Burke, 381 A.2d 1358 (1977), *cert. denied*, 435 U.S. 972 (1978); Eastern Edison Co. v. Department of Public Utilities, 388 Mass. 292, 446 N.E.2d 684 (1983); Office of the Public Counsellor v. Indiana & Michigan Electric Co., 416 N.E.2d 161, 164-165 (Ind. App. 1981); Public Service Co. v. Public Utilities Commission, 644 P.2d 933, 936-940 (Colo. 1982); Appeal of Sinclair Machine Products, Inc., 498 A.2d 696 (N.H. 1985); Spence v. Smyth, 686 P.2d 597 (Wyo. 1984); Washington Gas Light Co. v. Public Service Commission, 452 A.2d 375, 384-386 (D.C. App. 1982), *cert. denied*, 462 U.S. 1107 (1983).

The *Narragansett* doctrine is based on the "filed rate" doctrine, which arose in the Supreme Court's decision in Montana-Dakota Utilities Co. v. Northwestern Public Service Co., 341 U.S. 246, 251-252 (1952), wherein the Court stated that a company "can claim no rate as a legal right that is other than the filed rate, whether fixed or merely accepted by the Commission, and not even a court can authorize commerce in the commodity on other terms."

In establishing just and reasonable rates, the Commission determines not only the total revenue required by the utility to recover its costs and an appropriate rate of return on its investment, but also a just and reasonable allocation among wholesale customers of the total costs to be recovered by the utility. As previously stated, section 206 of the Act gives the Commission authority to amend contracts affecting rates. This includes contracts providing for allocation of costs or power. In cases involving transactions among closely coordinated interstate affiliates, the Commission has taken the position that it has preemptive authority to amend contracts among the interstate affiliates so as to establish cost allocations that are just and reasonable, and not unduly discriminatory or preferential. It has further taken the position that state action to disregard Commission-decided allocations not only contravenes the preemption doctrine, but also violates the Commerce Clause of the United States Constitution. 2/ In the Nantahala case, the Supreme Court upheld the Commission's preemptive authority under the Federal Power Act to alter allocations agreed upon by interstate affiliates. In addition, the Court held that the Commission's preemptive authority under the filed rate doctrine (see note 1) is not limited to rates per se, but also applies to the Commission's allocation of power between interstate affiliates when that allocation directly affects jurisdictional wholesale rates. The Commission's allocation determination, reflected in the wholesale utility's filed rate, must be respected by the state commission regulating applicable retail rates. Slip op. at 13-18. The Court's decision was based on the preemption doctrine and did not reach Commerce Clause arguments.

S. 1149 is likely to be challenged on the constitutional grounds that it may constitute an undue burden on interstate commerce violating the Commerce Clause of the United States Constitution. The issue raised by S. 1149 is whether or not a state under the Commerce Clause is required to implement the Commission's allocation of costs. "Economic protectionism"

2/ Nantahala Power and Light Company, et al. v. Utilities Commission of North Carolina, et al., No. 85-568 (U.S. June 17, 1986) ("Brief for the United States and the Federal Energy Regulatory Commission as Amici Curiae Supporting Appellants," dated January 1986); New Orleans Public Service Inc. v. City of New Orleans, et al., No. 85-3654 (5th Cir.) ("Brief for Federal Energy Regulatory Commission as Amicus Curiae," dated Nov. 22, 1985).

may be found on the basis of either discriminatory purpose or discriminatory effect. Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 104 S.Ct. 3049, 3055 (1984); Philadelphia v. New Jersey, 437 U.S. 617, 626 (1978). As the Eighth Circuit found with respect to an effort by the Arkansas Commission to protect the Arkansas ratepayers from the Grand Gulf costs, Middle South Energy, Inc. v. Arkansas Public Service Commission, 772 F.2d 404, 416-417 (8th Cir. 1985), an effort to protect the local ratepayers from Commission-allocated costs is suspect on two grounds: it amounts to a preference for citizens in one state gained at the expense of out-of-state customers. Because discriminatory in purpose, the state's action may not amount merely to evenhanded regulation with only incidental effects on interstate commerce. See also, Philadelphia v. New Jersey, 437 U.S. at 624; Hughes v. Oklahoma, 441 U.S. at 116; Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 36 (1980).

Moreover, this legislation involves a matter that is essentially national in scope, involving competing state interests that inherently call for the exercise of impartial Federal authority. Cf. South Central Timber Development, Inc. v. Wunnicke, 467 U.S. 82, 104 S. Ct. 2237, 2240 (1984) (the need to resolve such competing state interests is the fundamental justification for the Commerce Clause).

S. 1149 would substantially alter the state/Federal relationship described above by permitting individual states to override Commission decisions affecting interstate commerce, where those decisions involve certain transactions among affiliates of a utility holding company system. A major impact of the legislation, therefore, would be to divest the Commission of a major part of its jurisdiction over sales for resale in interstate commerce (specifically, those involving holding company power pools). Other major impacts would be to sanction potentially inconsistent and conflicting ratemaking decisions by more than one state commission regulating a single utility, and possibly to interfere with power pooling in the United States. These possible impacts are discussed below.

Many power pools operate on the premise that, in order to achieve greater economies and reliability, the pool members will operate on a coordinated basis and, from time to time, one of the companies will build a generating unit larger than necessary to meet its immediate needs. The company constructing the unit will share the output of the unit with other pool members until such time as it can absorb the unit's total output to meet the needs of its customers. Imbalances in the costs resulting from the construction are often shared by the pool members since the unit, at least initially, is used for the benefit of the entire system. The bill would allow certain state commissions to disregard the allocation of costs established by the Commission; further, the bill would allow the state commissions to disregard the actual rate level set by the Commission, even though they may agree with the allocation of costs. This would repudiate the Narragansett doctrine and the filed rate doctrine, upheld in the Supreme Court's recent decision in Nantahala.

Another potential issue presented by the proposed bill concerns Commission decisions regarding interpretations of power pool contracts. The Commission has held that it does not necessarily have exclusive jurisdiction with respect to interpretations of filings tendered to it pursuant to the Federal Power Act. However, it does have primary jurisdiction to decide questions on the interpretation and application of contracts within its jurisdiction and, once it has decided such a question of interpretation, a state commission is bound to follow that decision. AEP Generating Company, 32 FERC ¶ 61,364 (1985), rehearing pending. Under S. 1149, the same contract among affiliated companies subject to Commission jurisdiction could be subject to conflicting interpretations between or among two or more states and to conflicting interpretations between or among the Commission and one or more states. Such conflicting or inconsistent interpretations create serious uncertainty and potential to undermine long-term system planning and operation decisions.

Related to the above problem is the effect that S. 1149 would have on decisions concerning certain questions of prudence in entering power pooling transactions. In American Electric Power Service Corp., 32 FERC ¶ 61,363 (1985), rehearing pending, the Commission stated that the question of whether it was prudent for members of an integrated holding company system to enter into a transmission system cost equalization agreement could not be considered separately from broader questions concerning the prudence of being a member of the integrated system; the Commission characterized this inquiry as a preemptive Federal matter implicating the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79, et seq. Under S. 1149, state commissions in effect could veto Federal determinations based on findings regarding the prudence of entering into Commission-jurisdictional power pool contracts.

Still another possible effect of S. 1149 would be to discourage coordinated and integrated planning by affiliated members of power pools, and the economies achieved through such planning. Under the proposed legislation, a pool member would likely be disinclined to construct a unit larger than necessary to meet its immediate needs, i.e., a unit which would at least initially benefit the entire system, if it could not be assured that all companies would share in a portion of the unit's costs under an equitable cost-sharing method. From the perspective of the individual companies as well as the holding company system as a whole, there would be further disincentive to construct such units if there were a likelihood that part or all of the costs to be shared by other members might not be recovered through the applicable retail rates; shareholders of the system or the individual companies would have to absorb any amounts not ultimately recovered. Likewise, there would be little incentive for a state commission to approve construction of such a unit if the ratepayers in its state would have to bear all costs of a unit larger than its local ratepayers are expected to need. The legislation also could negatively affect the Commission's statutory duty under section 202(a) of the Act to promote and encourage interstate interconnection and coordination of facilities for the generation, transmission, and sale of electric energy.

Finally, it should be noted that the retroactivity imposed by section 3 of S. 1149 could pose additional problems in cases already decided by the Commission. This section makes the legislation applicable to any final order issued by the Commission on or after May 1, 1985. The decisions made by the Commission in past cases were based on the assumption that the Federal Power Act as now written, and legal decisions interpreting that Act and the Commission's jurisdiction under it, were to be applied. Under a different statutory framework, it is conceivable that the Commission might have reached a different decision.

In sum, it appears that S. 1149 would have a substantial impact on the Commission's jurisdiction and the state/Federal relationship insofar as certain interstate electric energy transactions are concerned, and it could also substantially affect the structure, operation, and objectives of holding company power pools in the United States.

If I can be of further assistance to you in this or any other Commission matter, please let me know.

Sincerely,

Christopher J. Warner

Christopher J. Warner
Associate General Counsel
Legislation, Regulation, and
Congressional Affairs

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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510

July 24, 1986

Mr. Christopher J. Warner
Associate General Counsel
Legislation, Regulation, and Congressional Affairs
Federal Energy Regulatory Commission
Washingtion, D.C. 20426

Dear Chris:

I have a question about your June 20 letter to Chairman McClure on S. 1149. The second paragraph on page 3 starts with the following sentence: "S. 1149 is likely to be challenged on the constitutional grounds that it may constitute an undue burden on interstate commerce violating the Commerce Clause of the United States Constitution." However, I find nothing in the remainder of that paragraph or anywhere else in the letter that explains the rationale for that sentence.

The Commerce Clause (U.S. CONST. art. I, § 8, Cl.3) gives the Congress power "To regulate Commerce with foreign nations, and among the several States, and with the Indian Tribes."

It is my understanding that under the Commerce Clause, Congress has plenary power to regulate interstate commerce. It is empowered to determine whether the interests of the nation are better served by uniform Federal regulation, or by nonuniform or more restrictive State control.

Where the Constitution grants to Congress the power to legislate, it may discharge its legislative function by adopting State laws, present or prospective. United States v. Sharpnack, 355 U.S. 286 (1958), Prudential Insurance Co. v. Benjamin, 328 U.S. 408 (1946). It may also remove the obstacles to State legislation which will permit the State itself to legislate directly on the subject. Butte City Water Co. v. Baker, 196 U.S. 119 (1905); In re Rahrer, 140 U.S. 545 (1891).

Moreover, the United States Supreme Court has recently reconfirmed that Congress may "confer upon the States an ability to restrict the flow of interstate commerce that they would not otherwise enjoy." Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 44 (1980). This is true notwithstanding the fact that the Commerce Clause contains an implied limitation on the power of the States to burden interstate commerce. See Cooley v. Board of Wardens, 53 U.S. 299 (1852). For, "if Congress ordains that the States may freely regulate an aspect of interstate commerce, any action taken by a State within the scope of the Congressional authorization is rendered invulnerable to Commerce Clause challenge." Western & Southern Life Insurance Co. v. State Board of Equalization, 451 U.S. 648, 652-3 (1981).

As Chief Justice Stone stated in Southern Pacific Co. v. Arizona 325 U.S. 761, 766-7 (1948),

> Congress has undoubted power to redefine the distribution of power over interstate commerce. It may either permit the States to regulate the commerce in manner which would otherwise not be permissible, or exclude State regulation even of matters of peculiarly local concern which nevertheless affect interstate commerce.

More recently, Chief Justice Burger pointed out a unanimous opinion of the Court,

> It is indeed well settled that Congress may use its powers under the Commerce Clause to confer upon the States an ability to restrict the flow of interstate commerce that they would not otherwise enjoy. The dispositive question, however, is whether Congress in fact has authorized the States to impose restrictions of the sort at issue here. New England Power Co. v. New Hampshire, 455 U.S. 331, 339-40 (1982)).

Opinions obviously differ over whether enactment of S. 1149 would be good public policy. However, if it became law how do you think it could be challenged on the grounds that it violated the Commerce Clause?

I look forward to your reply.

Sincerely,

Mike Harvey

D. Michael Harvey
Chief Counsel
for the Minority

DMH:cw

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

September 10, 1986

Mr. D. Michael Harvey
Chief Counsel for the Minority
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. ~~Harvey~~ Mike:

Thank you for your letter of July 24, 1986, concerning comments on S. 1149 which were submitted by me to Chairman McClure on June 20, 1986. Specifically, you question a reference to the Commerce Clause, contained on page 3 of the June 20 letter: "S. 1149 is likely to be challenged on the constitutional grounds that it may constitute an undue burden on interstate commerce violating the Commerce Clause of the United States Constitution." I appreciate the opportunity to clarify this reference.

As pointed out in your letter, United States Supreme Court case law supports Congress' authority to allow the states to place a burden on interstate commerce. The Court recently reaffirmed that "[w]here state or local government action is specifically authorized by Congress, it is not subject to the Commerce Clause even if it interferes with interstate commerce." White v. Massachusetts Council of Construction Employers, 460 U.S. 204, 213 (1983). It appears, however, that a limitation on Congress' authority to abdicate its regulation of interstate commerce to the states is that the abdication not otherwise violate the United States Constitution:

> The power of Congress over commerce exercised entirely without reference to coordinated action of the states is not restricted, except as the Constitution expressly provides, by any limitation which forbids it to discriminate against interstate commerce and in favor of local trade. Its plenary scope enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons. [Emphasis added]

Prudential Insurance Company v. Benjamin, 328 U.S. 408, 434 (1946).

Thus, a statute could be challenged if it gave to the states the right to interfere with commerce in such a way that other provisions of the Constitution were violated. While the Commission takes no position on the validity of the argument, it could be contended that implementation of S. 1149 would result in an uncompensated taking of a utility's property in violation of the Fifth and Fourteenth Amendments. This is because S. 1149 would permit states to refuse to allow a utility recovery of its costs as allocated by the Commission, arguably without due process of law.

A final point which was not explicitly made in my previous letter is that if S. 1149 were to pass constitutional muster, as a practical matter it likely would resurrect many of the problems which existed at the time of Public Utilities Commission v. Attleboro, 273 U.S. 83 (1927). Prior to Attleboro, there was no Federal regulation of wholesale electric rates and certain state actions were struck down by the courts as constituting direct burdens on interstate commerce. The Court in Attleboro declared that wholesale sales of electricity in interstate commerce were "essentially national" in character, and not subject to regulation by the states. Id. at 90. It reached its decision by relying on an earlier gas case in which it had found that the paramount interest involved in interstate wholesale gas sales was national in nature, and required uniformity of regulation which might be "highly necessary to preserve equality of opportunity and treatment among the various communities and states concerned." Missouri v. Kansas Gas Co., 265 U.S. 298, 309-310 (1924). Congress responded to Attleboro, and the regulatory gap created by it, by enacting the Federal Power Act some seven years later. S. 1149 therefore would partially overturn a major part of a comprehensive Federal regulatory scheme which provides for impartial regulation of competing interests among the states and assures no undue burden on interstate commerce.

I hope these comments clarify the June 20 letter. If I can be of further assistance to you in this or any other Commission matter, please let me know.

Sincerely,

Christopher J Warner

Christopher J. Warner
Acting General Counsel

JAMES A. McCLURE, IDAHO, CHAIRMAN

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United States Senate

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510-6150

September 16, 1986

Mr. Christopher J. Warner
Acting General Counsel
Federal Energy Regulatory Commission
Washington, D.C. 20426

Dear Chris:

Thanks for you September 10 response to my July 28 letter about S. 1149. I'm glad we agree that while the bill might be subject to challenge on other grounds, it is not likely to be challenged on the grounds that it constitutes an undue burden on interstate commerce.

Sincerely yours,

D. Michael Harvey

D. Michael Harvey

cc: Sen. Dale Bumpers
and other members

DMH:cw

Senator **Bumpers**. I am going to defer to Senator Pryor.

Senator **Pryor**. Mr. Martin, do you express the views of this administration when you oppose S. 1149?

Mr. **Martin**. Yes, I do. These are the administration's views.

Senator **Pryor**. Do you feel that is a fair decision for the Federal Energy Regulatory Commission to make to force one-third of the allocation upon the ratepayers of our State when we will not be utilizing the energy produced by these plants? Do you think that that is a fair decision?

Mr. **Martin**. Senator, you have to look at the benefits of regional pooling to the consumers of Arkansas.

Senator **Pryor**. Pardon.

Mr. **Martin**. You have to look at the broader benefits of regional pooling to the consumers of Arkansas, both in the past and in the future. Arkansas has benefited in the past by regional pooling. I believe the rates are about 80 percent of the national average.

Indeed in the future with Grand Gulf coming on board, even though there is a surplus now, in the future there will be adequacy of supply. So I think these two have served Arkansas well.

Senator **Pryor**. You talk about pooling. Are you saying that in the 1970's that consumers and ratepayers from other States assisted us in paying for our own generating plants?

Mr. **Martin**. No. I am saying that you did benefit from some of the——

Senator **Pryor**. We paid for our plants, we were not helped, nor did we ask the support of other States or ratepayers. Is this correct?

Mr. **Martin**. My understanding is that you have benefited from the pool of energy from the various States involved, including use of gas from Louisiana, your coal plants which are very competitive and low priced, as well as the nuclear power which is now coming on board.

Senator **Pryor**. Well, you oppose S. 1149 and the administration opposes it. What do you support? What do you think might be some way to achieve, let's say, equity for the ratepayers of Arkansas? Do you have a suggestion?

Mr. **Martin**. Well, I think first, let me tell you what we do not like about the legislation. We do not like the fact that it is retroactive ratemaking. We do not like the fact that we believe that it undercuts regional efficiency.

Now, Senator, you raised that you thought that we might help. That is an interesting point. Maybe we could look at that.

Third, we are concerned about undercutting incentives for future capital investment. At the moment, as others have testified, we face a surplus in electrical generating capacity around the country. We are in the process of completing a major electricity study which is looking beyond today into the 1990's and we estimate that somewhere between 100 and 300 gigawatts of electrical power will be necessary for this country.

That is very large scale. That is 100 to 300 plants. And even if one takes the estimates on the lower end of the scale, we believe that regional pooling, which I might add has increased from something like 25 percent in 1961 to perhaps up to 50 percent today, is an efficient approach from an economies of scale point of view.

So when we look at the situation in Arkansas, we do have sympathy for the ratepayers. I have read laborious accounts of this case in both the testimonies that you and Senator Bumpers have given about the hardship on the people. We too are concerned in the final analysis on the consumer here. We just believe that looking at the criteria I mentioned, price stability, adequacy of long-term supply, and efficiency of regional production, we believe with those three criteria, this bill does not help.

Senator **Pryor**. It sounds like to me that this administration is also saying that Grand Gulf II which has now for all practical purposes been mothballed should be paid for one-third by the people of Arkansas.

Is that the position of this administration?

Mr. **Martin**. I do not have a view on that because I have not studied the implications of that.

Senator **Pryor**. Who do you think should pay the cost of Grand Gulf II?

Mr. **Martin**. I do not have an opinion on that, Senator. I would like to look into it.

Senator **Pryor**. If I might ask the Federal Energy Regulatory Commission, who should pay the cost of Grand Gulf II?

Mr. **Warner**. Senator, I think that is an issue that would come before the Commission and be subject to a general public interest determination.

Senator **Pryor**. Will the Arkansas Public Service Commission be circumvented and preempted from making any decision or passing on any rates to the ratepayer relative to Grand Gulf II?

Mr. **Warner**. I just do not have any opinion as to what will occur prospectively in regard to Grand Gulf II.

Senator **Pryor**. When will that decision be made?

Mr. **Warner**. They have not come in before us. There is no pending issue before us relating to Grand Gulf II.

Senator **Pryor**. Should ratepayers pay for the mistakes of business decisions or should stockholders?

Mr. **Warner**. One of the classic statements of the obligation of a regulator in the public utility sense is to balance the interests of the ratepayers and the shareholders. It has been stated time and time again in the court precedents as the public interest standard that regulators must apply.

Of course, it is different in different cases. Each case turns upon its individual facts and circumstances. But in terms of who should bear the risk, I think that commissions generally review each case on its own circumstances and make decisions and attempt to apply the public interest standard and balance the risks.

Senator **Pryor**. Well, if you balance the risk and balance the payments basically in equities, then it would be conceivable under that theory for the people of Arkansas and the ratepayers of our State to go back to Middle South and say OK, we are going to pay for Grand Gulf I which has now been put on our backs, and we are going to ask now that the people and the ratepayers of Louisiana and Mississippi pay at least one-third of the cost for the power generating plants that we built in the 1970's.

Would that fall under your philosophy of balancing the equities?

Mr. Warner. I just could not express an individual opinion on the circumstances, especially when we do not have a pending matter before us.

Senator Pryor. I think that is all.

Senator Bumpers. Mr. Martin, you said you did not have an opinion on Grand Gulf II. Are you familiar with the fact that the Secretary of Energy went down to Mississippi and testified that Grand Gulf II ought to be finished, no matter what.

Mr. Martin. You are talking about Secretary Hodel at the time he was Secretary of Energy? You are referring to Secretary Hodel when he was Secretary?

Senator Bumpers. He was Secretary of Energy at that time; that is right.

Mr. Martin. I am aware that he gave testimony at that time. I believe his testimony focused on the need for nuclear power as well, the importance of nuclear power for a mix of diverse sources of energy. I have read that testimony.

Mr. Herod. I was at that hearing when Secretary Hodel testified. He did not express a specific opinion on whether or not Grand Gulf II should be completed or not. He came down to offer a national perspective on the issues of supply sufficiency in the region and the Nation as a whole .

Senator Bumpers. Well, I can tell you that the press badly mismanaged that story if that is what he said, because every story I read said that the Secretary was urging completion of Grand Gulf II in light of the fact of all the nuclear power that we were going to need in the future.

And you were there?

Mr. Herod. Yes, sir; I was.

Senator Bumpers. You did not hear it that way?

Mr. Herod. Yes, that is correct.

Senator Bumpers. Well, let me ask you this, Mr. Martin. You state in your testimony that we are going to need between 100 and 300 gigawatts of new generating capacity by the end of the century.

Now, just to show you the problems that this committee has in dealing with this sort of thing, I want to point out that 4 years ago the Department of Energy was saying we were going to need 438 gigawatts, 4 times as much as you now say we are going to need.

How are we to deal with questions like that?

Mr. Herod. The study that was put out in 1983 also used a range of estimates that ranged as high as 438 gigawatts and did not really assume demand growth much different than what we are looking at 3 years later. So these estimates really have not changed substantially.

One reason that the number is somewhat lower here 3 years later is that we have had quite a bit of capacity coming out of the construction pipeline in the last 3 or 4 years, so we no longer show it as a future need since it is already committed, but the actual demand projections are not substantially different.

Senator Bumpers. Let me also point out, Mr. Herod, that 4 years ago when you were saying we were going to need 438 gigawatts of additional power by the year 2000 at a cost of $1.8 trillion, we also did not have a 38-percent reserve power pool either, and if we had had less—if we had had like 20 percent, 15 to 20, which is considered adequate by national standards, we would have been recommending back then that we have 600 gigawatts of additional power by the end of the century, and now you are saying we need 100 and 300.

All I am saying is we are all fallible. I understand that. Nobody can predict with any degree of certainty, but you can see how difficult our job is in trying to decide which way to go so far as energy itself is concerned.

Now, let me ask Mr. Warner this question. You are taking strong exception to S. 1149, and the principal reason for this bill is to stop the rush to FERC for jurisdiction. And when your boss who is Chairman of the Commission, Mr. Sousa, came over here for his confirmation hearing last year, here was my question:

> Mr. Sousa, do you believe that holding companies are attempting to circumvent local law by rushing to FERC's jurisdiction?

And here is his answer:

> I am aware, Senator, of that trend where corporations have sought to circumvent local regulation by trying to come under the jurisdiction of the FERC. And perhaps that is an area where Congress should be enacting some laws to avoid that kind of circumvention.
>
> I also am aware of the advice being given by so-called consultants on how to circumvent or avoid local regulation by coming under the umbrella of Federal regulation. That is part of the strategy that these people have used to go to the holding company situation, to get into that situation where they can avoid State regulations and get Federal regulation.

Now, if Chairman Sousa thinks something ought to be done about it, why do you not think something should be done about it?

Mr. WARNER. Senator, we are not taking a position on whether or not something should be done about it in terms of our jurisdiction.

Senator BUMPERS. You are just saying S. 1149 is not the right vehicle?

Mr. WARNER. No, I think we are saying that it raises certain issues which you should address; namely, the issue of impact on power pool planning, the issue of its impact on coordination.

At the same time, as I remember Acting Chairman Sousa, he agreed with you that there is an issue as to the resort to one forum or another. I think the important aspect of our current jurisdiction is that if issues are raised as to alleged forum shopping, or if State commissions come in and intervene at the Commission and raise the issue as to the public interest of a particular entity coming before the FERC as opposed to another body, that issue can be raised and the Commission is obligated to consider it in its application of the overall public interest standard.

It is a matter of balancing, I think, the encouragement that Congress has given the Commission to undertake in the coordination and reliability of interstate transmission facilities for electricity, a balancing of that encouragement as contained in PURPA and other laws, including the Federal Power Act itself, balancing that with the overall public interest standard, to the extent possible deferring to the States in their traditional role of——

Senator BUMPERS. FERC has just about taken the State's traditional role, Mr. Warner. We do not have enough role left in Arkansas to wet a whistle, because FERC has taken away all of our regulatory authority down there.

We are not pressed for time, but I do not want to take too much time on that issue. I do want to make a couple of other points, and that is——

Senator BRADLEY. Would you yield on one point?

Senator BUMPERS. Certainly.

Senator BRADLEY. I would like to stay, but I cannot stay. I must say I put myself in the position of the two Senators from Arkansas, and I have no relatives in Arkansas. I have had Mountain Valley Water occasionally at a hot baseball game on a summer afternoon, but I do not have an interest in the Arkansas qua Arkansas situation.

What I have an interest in is putting myself in their position and saying, could it happen to me in New Jersey. I must say, if my constituents had to pay for electricity that they did not want, they did not need, and that they did not ask to purchase in the first place, I think I would be right here where these two Senators are and as outraged as they are.

Senator BUMPERS. I thank the Senator very much, and I thank you for coming by this afternoon. I know the Finance Committee is busily engaged this afternoon, and it makes us doubly grateful.

Let me just make a couple of other points, Mr. Warner. When it comes to power pooling, it seems to me that the *Grand Gulf* decision by FERC is one of the greatest impediments to power pooling that has ever been handed down.

Why would not consortiums who want to get involved in power pooling not prefer this kind of legislation? Why would the people of the States that they serve not welcome this kind of legislation which adds a tremendous amount of certainty to the uncertainties that now exist?

In that connection, this point was made in my opening statement. Why would not the financial markets of this country welcome this kind of legislation that says all you have to do is go to your respective regulatory authorities and say we want to participate to the extent of 25 percent in this plant. Our share will be $500 million. We need the power. Here is how much we have. Here is how much we will get.

They go and they get FERC jurisdiction after that because it is a wholesale sale of power. That is no problem. They should have no problem getting financing, because they have already gotten prior approval under the law, and there is that degree of certainty. Once that authority has been given, it will not be lightly taken away.

Now, if they come back 5 years later and say, I am sorry, our cost is $1 billion instead of $500 million, then the proper regulatory authority certainly would have a right to decide if that extra $500 million was prudently spent and if it was necessary.

That is about all they would be looking into. They would not have granted permission in the first place if they could have bought the power cheaper someplace else. They would not have given them permission in the first place unless they knew they needed the power.

It seems to me that it adds all kinds of certainty to the situation that financial markets would love. Now, why is that not an accurate statement?

Mr. **Warner**. Mr. Chairman, I cannot speak for the utilities themselves, but I think one of the issues you need to address is the potential for inconsistent State utility commission decisions in a situation such as that.

One of the threshold questions that the Commission did face in the *Middle South* litigation was determining whether the Middle South System was operated as a single, integrated, coordinated system in which planning for generating units was done on a systemwide basis.

I think the question you need to ask yourself is——

Senator **Bumpers**. Incidentally, there is no quarrel with that. We were operating under the Public Utility Holding Company Act of 1935, which required us to operate as an integrated system. We never denied that, but we operated under contracts. Those contracts were all honored. For 40 years they were honored, until FERC comes in and says we do not like this contract. We are going to change the whole arrangement.

Mr. **Warner**. The issues that were brought before the Commission prior to the Commission making its decision in the *Middle South* litigation were raised by many different parties, and the parties did not agree. The parties had different views as to the allocation of costs, as to equalization, and as to even an interpretation of whether planning was done on a systemwide basis or was done in an autonomous fashion.

I think the Commission learned in a very realistic way that on an issue such as the allocation of costs from a generating unit like Grand Gulf that many parties to the original agreements could have differing views, and the different institutions representing the States involved had different views as to where the public interest——

Senator **Bumpers**. You are a lawyer, are you not, Mr. Warner?

Mr. **Warner**. Yes, sir.

Senator **Bumpers**. Were you not taught the sanctity of contracts in law school?

Mr. **Warner**. Of course, I was taught the sanctity of contracts. Here, the Commission was exercising the jurisdiction that Congress had provided to it to modify such contracts, to review such contracts, and to determine whether the allocation of costs under those contracts was just and reasonable and not unduly discriminatory. So the Commission did exercise jurisdiction that it viewed——

Senator **Bumpers**. They just threw that contract in the wastebasket and said here is the new deal.

Mr. **Warner**. Parties raised many issues regarding the allocation under that contract. Extensive records——

Senator **Bumpers**. But they were signatories. The people who raised the issue were also signatories. They are big, grownup boys. They knew what they were signing when they signed it.

Mr. **Warner**. The *Mobile Sierra* line of cases, in terms of contracts, does provide that exception, that the Commission does retain the jurisdiction and the discretion to modify contracts prospectively where the Commission does find that they are unjust, unreasonable, or unduly discriminatory. That is exactly what the Commission affirmed in the administrative law judge's decision in the *Middle South* cases.

Senator **Bumpers**. Mr. Warner, we are going to run out of time. Let me ask one quick question. Has FERC ever ordered anybody to purchase power before?

Mr. **Warner**. I do not know the answer to that question.

Senator **Bumpers**. I can answer it for you. They have not.

No. 2, do you know whether or not FERC has ever ordered a production cost equalization of this magnitude before? I know that they have had transmission cost equalization, but have they ever equalized electrical generating capacity?

I will answer that one for you, too. The answer is no. They never have. They just came up with all those new gimmicks, new precedents nobody had ever heard of before, in order to reach a predetermined decision.

Thank you for coming.

Senator **Pryor**. Could I ask one question, too, Senator Bumpers?

Would you think, Mr. Warner, that it is permissible for the Federal Energy Regulatory Commission to order ratepayers to pay for reserves 65 percent to 100 percent above what we need, when the utilities are actually saying they need only 20 percent? Is that permissible?

Mr. **Warner**. Can I clarify your question? The question is, does the Commission have the jurisdiction to allocate the costs?

Senator **Pryor**. No, does the Commission have the power to order ratepayers to pay for more reserves than utilities even say they need in reserve?

Mr. **Warner**. I do not think I have an answer to that question, but I think that the Middle South case stands for the precedent that the Commission does have the authority when it does find that a particular allocation of costs among the affiliates of a holding company is unjust or unreasonable or unduly discriminatory.

It has the authority, in fact, it has the mandate under the Federal Power Act to go forward to fix the allocation of costs that would be just, reasonable and not unduly discriminatory.

Senator **Pryor**. If you sense a deep feeling of frustration by Senators Bumpers and Pryor, you better believe that it is sincere, and it is deep. We have not ever had this opportunity to visit with people like yourselves and talk to members of the Federal Energy Regulatory Commission. We do not get that opportunity. This is the first we have really had, to the best of my knowledge.

We are deeply frustrated and deeply troubled by this decision because, as Senator Bumpers said, we think you have preempted an historic and a traditional State right.

Let me ask this question, and this is my last one, maybe. This is for Mr. Martin.

Mr. Martin, think about this. This administration of President Reagan is generally perceived to be an administration that believes in States' rights. Philosophically, that would be what I would think that this administration has stated, at any rate.

Now, this administration has also said they do not like to preempt State ratemaking authority. How would you explain this increasing role of the Federal Energy Regulatory Commission's activity and what it has been playing in supplanting this traditional authority? What has happened here in the field of energy?

Mr. **Martin**. I think we do recognize the importance of States' rights in the administration. This is an issue on this particular legislation, and it was debated. We recognize that State authorities better understand their local consumers and their customer needs.

At the same time, we have a commodity here which is quite an extensive, what we call, interstate commodity. As I mentioned before, the figure of 50 percent of electricity now moving is in the interstate market.

Senator **Pryor**. Does that mean that FERC is going to take jurisdiction over 50 percent of the energy in America?

Mr. **Martin**. In those cases of wholesale trade, which is now the present law, the answer is that is correct.

Senator **Pryor**. If they go to FERC before they get to the State public service commissions, is that not correct?

Mr. **Martin**. We are also aware that——

Senator **Pryor**. It is a race to the court house. It is a race to FERC.

Mr. **Martin**. Sir, we also are aware that the interstate commerce clause of the constitution reserves the right of regulation to the Federal authority.

Senator **Pryor**. There is also a due process clause that I do not think the Federal Energy Regulatory Commission considered when it did what it did to the people of Arkansas, who did not need this energy nor want this energy and certainly, we felt, had no obligation to pay for it.

This administration takes the opposite position.

Mr. **Martin**. The administration takes the view that the regional pooling is important for electrical generation. In the past, Arkansas has benefitted because the prices were lower than the national average, and we believe in the future they will benefit from the regional pooling scheme, particularly in the 1990's where we foresee inadequate supplies of electrical generation.

I guarantee, Senator, when we come to the issue of electrical power policy in general, we want to work with you, with Chairman McClure and with others to wrestle with this issue. Your bill identifies some terribly important issues here. I think what we are saying is let us step back and look at the whole electrical power situation in the future so that we can assure our consumers everywhere adequate supplies of electricity at reasonable cost.

That is our objective. I think you share that, as well, and we will work with you in the fall as these studies become more available.

Mr. **Warner**. Mr. Chairman, I might add that Acting Chairman Sousa, as you know, has discussed this with you before. As a former State regulator himself, he understands the importance of this issue and wants to be as totally responsive to the committee and to you on this issue as he can.

Senator **Bumpers**. Mr. Warner, do you favor at least the modification, if not the outright repeal, of the *Narranganset* doctrine?

Mr. **Warner**. I do not have a personal opinion.

Senator **Bumpers**. You do not?

Mr. **Warner**. No, I do not, Senator, either way.

Senator **Bumpers**. Thank you both for coming.

Our second panel consists of the Honorable Steve Clark, attorney general from Arkansas; the Honorable Mary Sue Terry, attorney general, State of Virginia; Mr. William Spratley, Ohio Consumer's Counsel on behalf of the National Association of State Utility Consumer Advocates; Mr. Alan Nogee, energy analyst, Environmental Action Foundation; and Mr. Asa Hutchinson, Forth Smith, AR.

Senator PRYOR. Senator Bumpers has had to step out of the hearing room temporarily. He will return in just a moment. Even though I am not a member of this committee, I have been granted just about 5 minutes of authority to at least get this hearing moving.

Thank you very much, all of you, for attending. I do not know whether each of you has prepared a statement or not. I think it would be the committee's preference, as stated by Chairman Murkowski a few moments ago upon opening, that you try to keep statements as brief as possible, to under 5 minutes and, when and if you can, to summarize those statements.

We will proceed with the attorney general from Arkansas, Mr. Steve Clark.

STATEMENT OF STEVE CLARK, ATTORNEY GENERAL, STATE OF ARKANSAS

Mr. CLARK. Thank you, Senator. I appreciate the opportunity to appear before this committee.

Having heard the testimony that has gone on before, I think it would be fair to say that, having heard Senator Bumpers' testimony, and your testimony, and that of Governor Clinton, that I come from the "amen" role in terms of expressing Arkansas' frustration about this issue.

It is my job, as the State's lawyer, to be the people's lawyer. It is my job, by statutory mandate, to represent the people of the State of Arkansas, all classes of those people, residential, small business, large industrial commercial, in utility proceedings at both the State and Federal levels.

Someone was asked about the practical impact of S. 1149 a few minutes ago. It is my judgment, as the people's lawyer, that the practical impact is to give the people a voice in this process, and that is the reason that I support this legislation so very strongly.

It is clearly my opinion, as the State's chief legal officer, that FERC did exceed the power granted to it by Congress in the decision in the *Grand Gulf* case, but this Arkansas problem does not just originate with Grand Gulf and stop right there.

As you are probably aware, Arkansas is a State that operates with a number of utility-holding companies, and we have a project in the city of Brownsville, TX, called south Texas nuclear power project, which is part of the central southwest power pool, in which we have fought this very same issue once again. The question is there that the high cost of electricity could not be borne by the city of Brownsville, and, therefore, they asked that other operating companies bear the expense of a nuclear powerplant. Those operating companies include Swepco, Southwestern Electric Power Co., which serves Arkansas, Texas, and Louisiana.

This issue also does not deal just with nuclear powerplants, as we heard from the Kentucky experience. The construction of generation capacity is very expensive, regardless of the nature of that generation capacity.

We have also heard that the importance of S. 1149 is the fact that it guarantees a right to be heard, a State right to be involved in the process. My office and the Arkansas Public Service Commission for the last 3 weeks has been involved in fighting what we consider the FERC's latest move in this battle for utility, financial security in a docket called *New England Power Co.*, in which the FERC is actually considering a policy which would require ratepayers to pay back every penny invested in a nuclear powerplant or any powerplant which is not even completed.

If that policy were to be adopted by the FERC, once again not giving the State and its people any right to a voice in that process, it would require that Arkansas ratepayers pay for all of Grand Gulf II, a plant that is not complete, is not going to be completed, will never generate 1 kilowatt of electricity, and yet the ratepayers of Arkansas, the electrical consumers, are being told, if this policy is adopted, to pay for that electricity.

I think basically there are two points that I would like to make in concluding my remarks. I have listened to the response that S. 1149 might be retroactive and, therefore, unconstitutional. I totally disagree with that.

As I read S. 1149, it is not confiscatory. It does not say if adopted that in fact decisions made by the FERC will be reversed. It says that before a decision is made that a State regulatory body has an opportunity to review the matter. They may agree with a proposal from a power company. It does not say they will disagree.

It just says that the people have a right to participate in that decision. I do not think that is retroactive. I really think that is fundamental fairness, frankly. That is the due process opportunity of being heard.

I have also heard the comments being made about conflicting utility regulation and conflicts between the State and Federal levels. In my career in public service, part of my time I served as the chief of staff in the governor's office, that of Governor Pryor before he became a U.S. Senator.

One of the things that he taught me was that you always use the exception to prove the rule. In this instance, if you have one exception—and there is an exception perhaps—I do not know because the conflict was never spelled out, it was just argued that it might exist—I believe that there are reasonable minds sitting around these tables in terms of witnesses and obviously the Members of Senate and their staff who can resolve those conflicts. If in fact these conflicts do exist and are not just hypothetical, this legislation can be modified to address those.

Finally, I would simply say this. Also, in my career I was a law professor. Once in my tenure as a law professor, in working with a couple of my colleagues on an issue which we had about as much zeal as I and other people from Arkansas have in this matter, we had prepared the best briefs we knew how to prepare, reviewing all the cases we needed to review. We had prepared our best, oral argument and had advanced it in the most persuasive manner that we knew how.

Our concluding comment came from my colleague as he stood before a body who had the power to make a decision to influence good, positive, public policy. He said to that body, you know, I have given you the best cases, and I have given you the best argument, but if you don't accept any of that, I wish you would remember this. As I was growing up, my daddy taught me that when something just ain't right, it ain't right.

This is one of those cases that without S. 1149 we have an it ain't right situation. The it ain't right rule applies. It is just not right that the FERC have this kind of power and strip the States of their ability to participate. S. 1149, in my judgment, makes it right. It makes it right in the sense of fundamental fairness. It makes it right constitutionally. It makes it right in the scheme of the Federal Power Act as it was envisoned and adopted by the Congress and the powers that it bestowed upon the FERC, which are not powers that it has in fact taken.

Thank you very much for letting me appear here.

[The prepared statement of Mr. Clark follows:]

BEFORE THE SUBCOMMITTEE
ON WATER AND POWER

TESTIMONY OF STEVE CLARK
ATTORNEY GENERAL
STATE OF ARKANSAS

To the members of the Subcommittee on Water and Power, thank you for allowing me to appear before you today. My name is Steve Clark and I am the Attorney General in the State of Arkansas.

It is my statutory duty to intervene in utility rate proceedings, both federal and state jurisdictions, on behalf of the Arkansas ratepayers. I am here today to support Senator Bumpers' Ratepayer Protection Act of 1985 (S. 1149).

It is my opinion that the Federal Power Act of 1935, as it was then written and as it now stands, precludes the FERC from doing what they did to Arkansas. It was clearly the intent of Congress that the FERC have no authority to order any power company to expand generating facilities. The FERC does not understand that. Ultimately the FERC should receive that message from Congress. I am here today to support Senator Bumpers because his bill will send that message to FERC.

This problem is not just an Arkansas problem. The city of Brownsville, Texas has appealed a ruling from an administrative law judge to the full FERC Commission. If the Commission reverses the judge, we have another Grand Gulf situation in Texas, and again, Louisiana and Arkansas, with the South Texas Nuclear Project. Brownsville found itself caught with a potentially high electric bill from Central Power and Light. Central is a subsidiary of Central and South West. Brownsville asked the FERC to allocate the system costs evenly to all of Central and Southwest's operating companies. One of the operating companies, SWEPCO, generates power to customers in Texas, Louisiana and Arkansas. So, again, we in Arkansas were faced with potential payment for a high-cost nuclear facility in a different state that we didn't need, didn't want, and certainly did not approve.

I was a very active intervenor in that case at the FERC and persuaded the administrative law judge that the Federal Power Act precluded him from ruling in favor of Brownsville. Again, Brownsville has appealed that order to the full FERC and it is pending.

I want to emphasize to the subcommittee that this problem can happen in any state where your constituents are ratepayers to an operating company involved in a holding company or power pool situation. This problem can happen in any state where an operating company is a participant in the construction or financing of a baseload plant. And, that plant certainly does not have to be a nuclear facility. In today's energy and economic environment, baseload construction and financing is very expensive no matter what type of fuel is utilized.

Rather than burden you with the lengthy history of the Grand Gulf situation through the FERC proceedings, my objective today is to enlighten you to the present and future problems of Grand Gulf.

It is clear to me that the FERC has gone beyond their authority in the Grand Gulf I case. The result of that order is an outrage and is a very heavy economic burden on my state. As Senator Bumpers has told you, a large portion of Arkansas production is agricultural in nature and dependent on electric power at a reasonable price. Another large portion of the Arkansas population is on a fixed income. Rising electric bills cause these people to conserve on food and other necessities. Arkansas ratepayers look to their own PSC for protection against unreasonable rates and cannot believe what the FERC has done in the Grand Gulf I matter. The greatest fear of theirs, and mine, is that the FERC will reverse the law judge in the Central and South West case, or even more economically devastating, allocate any portion of Grand Gulf II to Arkansas.

Grand Gulf II is a nuclear facility that is only one-third complete. It will be cancelled. It will never generate power. It will never provide interstate commerce, and, hence, I will never back down to Middle South or the FERC when that issue shows its ugly face. Middle South will soon ask the FERC to order retail ratepayers to pay for the Grand Gulf II mistake.

The FERC needs a message from Congress. I am here today to support S. 1149 because Senator Bumpers is sending that message to the FERC.

Thank you.

Senator **Bumpers**. Thank you, Mr. Clark.

Ms. Terry, we welcome you to the committee, and you may proceed.

STATEMENT OF MARY SUE TERRY, ATTORNEY GENERAL, STATE OF VIRGINIA

Ms. **Terry**. Thank you, Senator Bumpers and Senator Pryor. My name is Mary Sue Terry, and I am the attorney general of the Commonwealth of Virginia. I am pleased here today to join my colleagues from Arkansas and Kentucky to testify on behalf of S. 1149 and to express the judgment of my office on this important measure before this committee. I want to take this opportunity to thank the subcommittee for offering me this opportunity to testify.

By statute, the attorney general of Virginia is charged with representing utility customers. Ratepayer protection is a matter of great importance to me and to my office, and we have dedicated a significant effort to it.

This statutory duty to represent consumers gives rise to our interest in S. 1149. A large majority of the retail electric service in Virginia is provided by Appalachian Power Co. and Virginia Electric & Power Co. Substantial numbers of Virginia citizens receive retail electric service from these companies. The retail electric rates for these systems are set by the Virginia State Corporation Commission.

Both Apco and Vepco are wholly owned subsidiaries of holding companies. Apco is owned by American Electric Power Co., a registered holding company under the Public Utility Holding Company Act. Vepco is a wholly owned subsidiary of Dominion Resources, Inc., an exempt holding company under the Holding Company Act.

A portion of Virginia is also served by Potomac Edison Co., a subsidiary of Allegheny Power System, a registered holding company under the act.

Virginia's experience demonstrates the broad applicability that S. 1149 would have in stabilizing the boundaries of Federal and State jurisdiction in the electric utility industry. Here are two examples:

In 1983, when Dominion Resources was formed and became the parent of Vepco, part of the company's planning included ownership of future electric generating plants by a separate Dominion Resources subsidiary, the power to be sold at wholesale to Vepco for resale to Virginia customers.

One purpose of this plan was to shift jurisdiction to FERC from the Virginia State Corporation Commission. Dominion Resources and Vepco abandoned the generating subsidiary concept, and the Virginia commission, in an order to which the companies agreed, enjoined the creation of generating company subsidiaries.

The second example: The Appalachian Power Co. and the other AEP operating subsidiaries have an interconnection agreement which allocates capacity costs on the AEP system. Through the allocation methodology, Apco can be allocated capacity charges based upon plant construction in other States by the other AEP companies, even though Apco State regulators have no regulatory oversight or authority over the new construction.

AEP is also currently seeking FERC authority to allocate transmission costs in a similar fashion which would shift costs to Appalachian for powerlines constructed outside of Appalachian service territory by other countries. State regulatory authority over inclusion of these transmission costs in retail electric rates is now the subject of litigation.

Mr. Chairman, retail electric rates are the subject of traditional State regulation. Since the adoption of the Federal Power Act in 1935, retail electric customers have relied on the delicate balance between Federal and State jurisdiction to set their electric rates. The consequences of a shift in the jurisdictional balance can significantly affect the utility bills paid by retail customers, perhaps requiring them to shoulder millions of dollars of additional expense even where their State commission has had no opportunity to approve construction of the facilities causing the increase in costs and rates.

This legislation is needed to preserve the delicate Federal/State jurisidictional balance originally intended by the Federal Power Act. S. 1149 is legislation which I wholeheartedly support. It is important legislation of broad applicability to many States.

Mr. Chairman, I hope the subcommittee will give it favorable consideration. Thank you.

[The prepared statement of Ms. Terry follows:]

STATEMENT OF
MARY SUE TERRY, ATTORNEY GENERAL
OF VIRGINIA

Before the Water and Power Subcommittee
of the
Senate Committee on Appropriations
July 23, 1986

May it please the Subcommittee, I am Mary Sue Terry, Attorney General of Virginia. Thank you for this opportunity to express my views on S. 1149, the Ratepayer Protection Act of 1985.

The Attorney General of Virginia represents the interests of utility customers pursuant to § 2.1-133.1 of the Code of Virginia. Ratepayer protection is a matter of great importance to my office and we have dedicated significant effort to it. This statutory duty to represent consumers gives rise to our interest in S. 1149.

A large majority of the retail electric service in Virginia is provided by Appalachian Power Company (APCO) and Virginia Electric and Power Company (VEPCO). Substantial numbers of Virginia's citizens receive retail electric service from these companies. The retail electric rates for these citizens are set by the Virginia State Corporation Commission.

Both APCO and VEPCO are wholly owned subsidiaries of holding companies. APCO is owned by American Electric Power, Inc. (AEP), a registered holding company under the Public Utility Holding

Company Act. VEPCO is a wholly owned subsidiary of Dominion Resources, Inc., an exempt holding company under the Holding Company Act. A portion of Virginia is also served by Potomac Edison Company, a subsidiary of Alleghany Power System, a registered holding company under the Act. Virginia's experience demonstrates the broad applicability S. 1149 would have in stabilizing the boundaries of Federal and State jurisdiction in the electric utility industries.

The Federal Energy Regulatory Commission (FERC) sets wholesale rates for the purchase and sale of electric power between power companies. Wholesale rates are often based on an allocation of energy from, or costs of, an electric generating plant. S. 1149 would amend the Federal Power Act to make clear that, where the State Commission regulating the purchasing utility has not approved construction of the plant, retail rates set by the State Commission need not automatically include all of the wholesale rate or charge set by the FERC to recover the costs of the plant. The bill would apply only to transactions between associated companies of a single holding company system.

Based on Virginia's experiences S. 1149 is needed to reassert the original intent of the Federal Power Act. Although State regulation of electric utility rates has been pervasive, the States' authority could not reach wholesale electricity sales in circumstances involving interstate commerce under Public Utilities Comm'n. v. Attleboro Steam and Electric Co. This created a gap in regulatory authority because, at the time Attleboro was decided, no Federal agency regulated electric rates. Congress passed the Federal Power Act in 1935, tailored to regulate interstate commerce and close the so-called "Attleboro gap." State jurisdiction was preserved under the Act. It was intended to supplement state jurisdiction, not supplant it.

Yet, in recent years, we have seen the Federal Power Act used to avoid state jurisdiction. Holding Company corporate structures can be used to shift jurisdiction between Federal and State agencies without any substantive change in the manner in which the utility system is operated. The Federal Power Act should not be read to completely supplant State jurisdiction, but that could occur as a practical matter.

For example, to oust State jurisdiction a vertically integrated electric company might simply divide itself in two, one half owning the generating facilities and the other owning the distribution system. The halves of the former whole could then purportedly engage in wholesale sales of electric power from the generating half to the distribution half, and thereby become subject to FERC, rather than State, jurisdiction. The State's authority to regulate retail rates could become a mere form because of the degree to which the distribution half's power costs, and therefore retail rates, would be determined by preemptive wholesale rates approved by the FERC for the generating half.

These are not theoretical or academic concerns without practical consequences. In 1983, when Dominion Resources was formed and became the parent of VEPCO, part of the companies' planning included ownership of future electric generating plants by a separate Dominion Resources subsidiary, the power to be sold at wholesale to VEPCO for resale to Virginia customers. One purpose of this plan was to shift jurisdiction to the FERC from the Virginia State Corporation Commission. Dominion Resources and VEPCO abandoned the generating subsidiary concept and the Virginia Commission, in an order to which the companies agreed, enjoined the creation of generating company subsidiaries.

Appalachian Power Company and the other AEP operating subsidiaries have an interconnection agreement which allocates capacity costs on the AEP system. Through the allocation methodology APCO can be allocated capacity charges based upon plant construction in other states by the other AEP companies even though APCO's state regulators have no regulatory oversight or authority over the new construction. AEP is also currently seeking FERC authority to allocate transmission costs in a similar fashion, which would shift costs to Appalachian for power lines constructed outside of Appalachian's service territory by other companies. State regulatory authority over inclusion of these transmission costs in retail electric rates is now the subject of litigation.

Middle South is not an isolated case of concern only to the States involved. Issues like those in Middle South can be expected to be raised more and more frequently. They threaten to undermine appropriate enforcement of the Federal Power Act and long-established State regulatory systems, in our view.

Retail electric rates are a subject of traditional state regulation. Since the adoption of the Federal Power Act in 1935, retail electric customers have relied on a delicate balance between Federal and State jurisdiction to set their electric rates. The consequences of a shift in the jurisdictional balance can significantly affect the utility bills paid by retail customers, perhaps requiring them to shoulder millions of dollars of additional expense, even where their state commission has had no opportunity to approve construction of the facilities causing the increase in costs and rates. This legislation is needed to preserve the delicate Federal-State jurisdictional balance intended by the Federal Power Act.

S. 1149 is legislation which I wholeheartedly support. It is important legislation of broad applicability to many States. I hope the subcommittee will give it favorable consideration. Thank you.

Senator BUMPERS. Thank you very much, Ms. Terry.

Mr. Nogee.

STATEMENT OF ALAN J. NOGEE, UTILITY ANALYST, ENVIRONMENTAL ACTION FOUNDATION

Mr. NOGEE. Thank you very much. My name is Alan Nogee. I am a utility analyst with the Environmental Action Foundation.

The question of who should regulate powerplant construction has enormous consequences to the United States. Over the last decade or so, electric utilities have invested well over $100 billion in powerplants that were subsequently canceled or are unneeded, or too expensive to be productive. We estimate that the annual cost of this wasted investment is close to $40 billion.

Regulators are now stuck with the thankless job of allocating these costs between utility ratepayers and investors. Their decisions will affect the economic vitality of entire regions. For example, one study found that the rate hike required to pay for the Shoreham nuclear plant on Long Island would cost that area between 35,000 and 49,000 jobs.

These decisions will also set the incentives governing future powerplant construction. Even the Electric Power Research Institute has concluded that one cause of past overbuilding was that, "a future penalty for overbuilding seemed small, and the possibility of paying that penalty remote." Clearly, any company faced with a virtually guaranteed return on a new construction project, regardless of whether that investment is needed or economical, will build the project.

State regulators are now moving to correct these past misincentives by requiring utility investors to share in the cost of overbuilding. The Federal Energy Regulatory Commission, however, has thus far refused to allocate any costs for excess capacity or imprudent management to utility investors.

In the rankings of every Wall Street firm, no regulatory commission anywhere is rated more generous to its investors than FERC. It is no surprise, therefore, that utilities are moving to place new construction under Federal rather than State jurisdiction, creating the potential for economic disaster.

Federal regulators do not have the resources of State agencies to investigate the prudence of utility construction projects. A prudence investigation of one nuclear plant typically costs millions of dollars. Most importantly, FERC is simply not accountable to those that have the largest stake in the results of utility investment decisions, the economic competitiveness of the States.

Congress can go far to correct the present problem by restoring a simple bright line between Federal and State regulatory jurisdiction. FERC is and should be responsible for setting the rates for interstate bulk power sales, but State regulators should be completely responsible for deciding if those bulk purchases were in the interest of the retail customer and how the cost of those purchases are allocated between investors and ratepayers.

Picture a situation, if you will, where a utility sells power to Consolidated Widgets. Imagine if regulators not only determined the price of the power but tried to determine how much that company should buy at the established price or whether the Widget Co. should pay for the increase by cutting its dividends or by raising widget prices.

If those are exactly the kind of determinations that FERC is making, not only setting the price Middle South Energy can charge retail companies for Grand Gulf but how much power those retail companies should buy and whether their stockholders or their customers who pay for it, those decisions which do not involve conflict between States but conflicts between retail utility investors and customers should be the sole province of State regulators.

As you mentioned earlier, Senator Bumpers, only a few years ago the Department of Energy was advocating that utilities invest another $1.8 trillion in new powerplants before the end of this century. Consider the potential consequences of guaranteeing now that utilities would be able to collect $400 billion a year from their customers to pay for this investment, regardless of whether it would prove to be necessary or not.

By the way, the Department of Energy may still be using the same demand projections that it was 4 years ago when it did that study, but since that time utilities have lowered their own demand forecasts by a good 40 percent or more.

These vital investment decisions should not be made by companies able to forum shop for the regultory agency most willing to guarantee those returns, especially in the light of the price that we are already paying for past utility overbuilding.

We hope that you will instead consider acting on S. 1149, particularly with modifications we discuss in our testimony; that is, removing the currently proposed limitations in the act that would apply only to holding companies, to generation and to States that have not certified construction.

Thank you very much.

[The prepared statement of Mr. Nogee follows:]

PREPARED STATEMENT OF ALAN J. NOGEE

SUMMARY

Electric utilities are moving to circumvent traditional state regulatory oversight of power plant construction costs in favor of the more lenient Federal Energy Regulatory Commission (FERC), by exploiting a gray of area of federal law. This jurisdictional transfer is coming as regulators grapple with the difficult problem of allocating approximately $40 billion a year in costs of utility over-investment--in abandoned plants, excess capacity and over-budget nuclear plants.

How these costs are allocated will have serious economic repercussions for many area economies, and will also establish the incentives governing a new round of expensive plant construction in the next decade.

Some state regulators are moving toward requiring a sharing of investment risks between utility customers and shareholders. In several states, they have had utility investors pick up part of the tab for excess capacity and imprudent construction practices. In contrast, FERC is allocating virtually all investment risk to utility customers. The agency has never disallowed any significant electric utility investment as imprudent or excess capacity. FERC ranks in the category most favorable to utility investors in the ratings of every Wall Street investment house.

FERC, moreover, is claiming pre-emptive authority over state commissions in a number of cases involving holding companies and power pools. FERC has exclusive authority, as defined in the Narragansett Doctrine, to review the reasonableness of wholesale rates of power sellers, and under current law as recently interpreted by the Supreme Court, to regulate inter-state contracts for capacity allocation.

FERC has recently extended its claims of exclusive authority to restrict state regulators from considering whether the decisions of the wholesale purchasing utility were prudent, and whether those costs should be allocated the the purchasing utility's shareholders or ratepayers. It is essential that state authority over allocating investment risks and costs between ratepayers and investors be maintained. State commissions have far more resources available to investigate and fully respond to local problems and opportunities. Most importantly, they are closer to and accountable to those who will ultimately gain or lose as a result of their decisions.

Congress should re-establish a bright line between jurisdictions based on the exclusive authority of FERC to regulate the rates of bulk power sellers, and state commissions to allocate costs of wholesale purchases between retail utility ratepayers and shareholders, just as they do for power plants wholly- or partially-owned by the retail utilities.

In order to most effectively accomplish this purpose, S 1149 should be modified so that its applicability is not limited to holding companies, to generation, or to states that have held certificate of need proceedings. Pre-approval of utility construction plans is only one element that can and should be considered in allocating investment risks and costs. States should not be limited in their authority to require utilities to conform more to marketplace standards for evaluating investment decisions.

Thank you Mr. Chairman. My name is Alan Nogee, and I have been a Utility Analyst with the Environmental Action Foundation for four years.

Environmental Action Foundation (EAF) has been providing technical assistance on electric utility issues to a network of hundreds of citizen groups and government officials for more than thirteen years. The Foundation also works closely with its sister organization, Environmental Action, which represents its members on energy and environmental issues in Washington.

My duties with the Foundation include research, writing and providing assistance to EAF's energy network. My 1984 study, Rate Shock: Confronting the Cost of Nuclear Power, examined the plant-by-plant and national cost to ratepayers of the 49 nuclear plants still under construction at that time. I have been invited to speak or testify before the House Energy Conservation and Power Subcommittee, the National Governors Association task force on nuclear plant financing, the National Conference of State Legislatures, New York and Pennsylvania legislative committees and numerous citizen groups. I am currently completing a study of the cost of excess generating capacity, and regularly write about electric utility issues in EAF's newsjournal, Power Line.

I appreciate this opportunity to discuss The Ratepayer Protection Act (S. 1149), and the regulatory relationship between the Federal Energy Regulatory Commission (FERC) and state commissions. We are very concerned that electric utilities have found a gray area of federal law which essentially enables them choose whether they will be regulated by state or federal government.

Lenient federal regulation is creating a powerful incentive for utilities to circumvent traditional state regulatory controls. Utilities across the country are moving to exploit this opportunity for forum-shopping by creating generating company subsidiaries subject to exclusive federal regulation. The Grand Gulf nuclear plant, which has imposed rate increases of 25 percent to 68 percent on ratepayers in the Southeast, is only the first major example of what could become a significant national trend.

Last year alone, at least four utilities--Tucson Electric, Public Service of New Mexico, Eastern Utilities Associates in New England, and South Carolina Electric & Gas--spun off new generating subsidiaries.[1] The literature is filled with discussions of the generating company strategy as a means of enabling utilities to build expensive new power plants, even when state regulators have adopted incentives to encourage alternatives to construction they believe to be unnecessary.[2]

We strongly support the intent of S. 1149 to help restore state authority over utility investments. In addition, we will suggest ways that the legislation could be modified in order to strengthen it and make it more broadly applicable.

THE PROBLEM: OVER-INVESTMENT IN NEW POWER PLANTS

The question of regulatory jurisdiction over utilities is vital to the present and future state of the U.S. economy. To clarify what is at stake, let us review the current state of power plant construction and costs.

Each year since the first oil shock of 1973, electric utilities have had to lower their forecasts of electric demand growth, as electric sales and peak demand failed to achieve predicted levels. At the same time, the cost of building new power plants, especially nuclear plants, escalated several times faster than an already-skyrocketing inflation rate.

As a result, billions of dollars have been sunk in unproductive power plant construction.

About $20 billion was invested in more than 100 nuclear and 75 coal plants that were canceled at various stages of planning and construction. The societal cost of this unproductive investment is about $4 billion a year.[3]

Despite these cancellations, we will still have almost 34 percent more generating capacity than needed to meet the peak electric demand expected this summer, well above the 15-20 percent reserve margin needed to ensure reliable electric supplies. This excess capacity represents an investment of approximately $75 billion, and a net annual cost of about $13 billion.

Additionally, we have about 30 nuclear plants still under construction that are so expensive that they are unlikely ever to pay back their capital investment through displacing less expensive fuels. My 1984 study, along with others about the same time, estimated that the nuclear plants then under construction would initially cost about $25 billion a year more than the plants they will displace.[4]

The allocation of approximately $40 billion in annual costs for utility over-investment has significant direct implications for the economic health of many local economies and of the U.S. economy as a whole. As household electric bills rise, less disposable income is available to purchase other goods and services. Local businesses are thus hit both with an increase in their own energy costs, and less income from consumer purchases. As companies attempt to pass through their increased costs in higher prices, and local governments pass through their increased costs in higher taxes, consumer spending must decline again, perpetuating a cycle of economic decline.

Businesses that compete with firms outside the area will see their competitiveness eroded by their higher energy costs. They may be forced to consider foregoing their own new investments, or even curtailing production or relocating to more favorable sites in other states or overseas. As large customers cut their use, the utility's fixed costs must then be spread over a smaller customer base, raising electric rates again.

Economic impact studies presented in regulatory proceedings in a number of states where rate hikes were requested to pay for new power plants have found that local employment would be ser'ously adversely affected. (See Table 1.) A study of the impact of projected Shoreham rate increases on the Long Island economy, for example, predicted a loss of 35,000-49,000 jobs, 37,000 families disqualified from the mortgage market, 2,000 home foreclosures and 11,000 families pushed below the poverty line.

But even more significant than the direct cost of current over-investment are the incentives that today's regulatory decisions create for future plant construction. While utilities and their critics vehemently disagree about the necessity and wisdom of a new round of plant construction in the next decade, all parties agree that how regulators treat today's excess capacity and construction costs will play a critical role in determining how much utilities will be willing to risk in new construction.

Last year, the Senate Energy Committee heard a wide range of testimony on the future of electric supply and demand in the U.S. On the one hand, some utilities believe that we will face serious supply shortages in the next decade. A 1982 report by the Department of Energy predicted a national need for 438 gigawatts (the equivalent of 438 large 1,000 megawatt nuclear plant) by the end of the century--at the phenomenal cost of 1.8 trillion dollars.[5]

Consumer advocates, however, point out that utilities have consistently over-forecasted growth in electric demand, and have predicted serious capacity shortages for many years. In 1975, for example, Donald Cook, chief of one of our largest utilities, said on Meet the Press that by 1979 or 1980 "there will be a power shortage in the United States that will make your hair curl." [6] Conservation advocates point to substantial evidence that improvements in energy efficiency, cogeneration and small power production could displace the need for most, if not all, central plant construction for the rest of this century--at a tiny fraction of the cost of building new power plants.[7]

Utilities, meanwhile, believe that current regulatory incentives discourage new central station plant investment. Consumer groups, on the other hand, believe that today's excess capacity is *de facto* evidence that existing regulatory incentives favor over-building.

Regulatory decisions about how to allocate the risks of construction investment therefore involve risks themselves. Allocating too large a share of costs to ratepayers risks damage to the local economy and continued over-building. Allocating costs to investors may risk increased capital costs and expensive power shortages. A recent analysis by the Congressional Budget Office estimates that the national cost of over-building to meet a 5 percent annual demand growth that failed to materialize would be $39 billion to $47 billion. The cost of under-investing by a like amount would cost $31 billion to $41 billion.[8]

ALLOCATION OF OVER-INVESTMENT COSTS

Utility regulators across the United States are thus faced today with the complex and difficult task of appropriately allocating these costs between different generations and classes of utility customers, and most importantly, between utility ratepayers and shareholders.

In allocating costs between utility customers and investors, regulators generally use one or more of three legal standards.

Utility commissioners usually look first at whether an investment was *prudent*. That is, was the decision to make the investment reasonable under the circumstances prevailing when it was made, and did the company manage the construction project reasonably well?[9]

Regulators may also evaluate investments by whether they actually turn out to be *used and useful*. This standard may justify excluding abandoned plants and excess capacity, as well as construction work in progress, from utility rates.[10]

Regulators may also judge the *efficiency* of the investment through a cost-benefit test. Will it create net savings for ratepayers, relative to other investment decisions the utility may have made?

Historically, the electric utility industry experienced declining costs as new more efficient power plants were added to utility rate bases. As a result, there was little concern with excess capacity, and little concern that costs would not be recovered. Even the Electric Power Research Institute concedes, in a recent study of demand forecasts over the last decade, that the presumption of virtually guaranteed recovery of investment helped spur over-building.

> "Senior utility executives probably judged the risk of not having enough generating capacity to be relatively great, perhaps recalling the experience of the Northeast Blackout. *In the early 1970s, a future penalty for overbuilding seemed small and the possibility of paying that penalty remote.*"[11]
>
> (emphasis added)

In recent years, as the cost of utility over-investment has grown, regulators in some states have begun to correct past incentives by allocating a portion of over-building costs to utility investors.

For abandoned plants, most commissions have allowed utilities to amortize the plants over a period of about 10 years. Utility investors thus recover their investments, but forego earning a return on the unamortized balance over that time. According to a study by the U.S. Energy Information Administration, this procedure allocates about 30 percent of total costs to utility ratepayers, 28 percent to shareholders, and 43 percent to taxpayers through write-offs of the bad investment.[12] (See Table 2 for major abandonment decisions.)

Regulators in several states have disallowed a portion of construction costs of recently completed plants as being imprudently incurred. The reasons for the adjustments have generally been unnecessary construction delays and inadequate management oversight. The largest prudence disallowance to date has assigned about one-third (of a $5000 per kilowatt plant) to utility shareholders, with most of the penalties considerably smaller. (See Table 3.)

State regulators have disallowed costs for excess capacity in about a dozen cases. In the largest recent excess capacity disallowance, regulators refused to allow Pennsylvania Power & Light stockholders to earn a return on any of the Susquehanna 2 plant. The Public Utilities Commission did allow the company to charge customers for interest on debt for the plant, and to collect for depreciation and operation and maintenance costs, however. Overall the excess capacity costs were thus shared about 50-50 between utility investors and customers.

Kansas recently became the first state to apply a strict efficiency test to a new power plant, as a result of 1984 state legislation. In addition to disallowances for imprudent construction management and excess capacity, the Kansas Corporation Commission valued the allowable fraction of the Wolf Creek nuclear plant's capacity at the $1290 per kilowatt a new coal plant would have cost, rather than at the $2700 per kilowatt the nuclear construction actually cost. Pennsylvania adopted similar legislation earlier this month, and pricing new utility plants at market-like rates is also being seriously considered in New Jersey, California, and Michigan and Massachusetts.[13]

In contrast to state utility commissions, the Federal Energy Regulatory Commission has never disallowed any fraction of electric utility investment in a new power plant on the grounds excess capacity. And despite "hundreds of requests" to do so, FERC has found imprudence only two times in relatively minor cases. Whereas state regulators have generally amortized canceled plants over about 10 years, FERC has usually used a 5-10 year period, placing more of the burden on ratepayers.[14]

The net result of these FERC policies is to require utility customers to bear virtually all risk associated with investment, completely insulating utilities from the consequences of their investment decisions. It is no surprise, therefore, that FERC is in the top-ranked category of every Wall Street investment house when they rate the generosity of regulatory agencies toward utility investors. (See Appendix 2.)

It is also no surprise, therefore, that utilities would want to transfer under FERC jurisdiction, particularly in regards to the allocation of construction risks and costs between ratepayers and shareholders.

FEDERAL PRE-EMPTION OF STATE REGULATION

In a number of cases around the country, the FERC has recently attempted to pre-empt state regulation over the prudence of utility investments. In addition to the Grand Gulf case, FERC has attempted to prevent state regulators from reviewing prudence in cases in Kentucky, West Virginia and North Carolina [15].

Federal regulation has its origins in the 1927 U.S. Supreme Court case, Public Utilities Commission vs. Attleboro Steam & Electric Co.[16] In that case, the Court established that retail utility sales, being "essentially local" in nature, were properly subject to state regulation, but that wholesale exchanges generally involved inter-state commerce and were "essentially national" in character, and could only be regulated by the federal government under the Commerce Clause. As there was no federal utility regulatory agency at the time, Congress created the Federal Power Commission in 1935 to fill the "Attleboro gap."

FERC's pre-emptive authority over state regulation is epitomized in what has become known as the Narragansett Doctrine. In 1977, the Rhode Island Supreme Court struck down a state commission ruling blocking the Narragansett Electric Co. from passing through costs to ratepayers for power the utility had purchased from the New England Power Co. (NEPCO). The commission had ruled the costs were "unreasonable" and "strikingly" or "glaringly unfair."[17] But the courts ruled that the state commission must accept FERC-approved costs as reasonable, and therefore could not exclude them from retail rates.

In addition, the "filed-rate" doctrine, as articulated in Montana-Dakota Utilities Co. v. Northwestern Public Service Co. holds that rates established by or filed with FERC "must be given binding effect by state utility commissions determining inrastate rates." State commissions are not entitled to "trap" costs that FERC allows the seller to charge the wholesaler by not allowing the wholesaler to pass them on in retail sales, according to a recent U.S. Supreme Court decision in Nantahala Power & Light v. Thornburg.[18]

An exception to the Narragansett Doctrine was created, however, in 1983 in Pike County Light & Power Co. vs. Pennsylvania Public Utility

Commission.[19] In that case, the Pennsylvania Commonwealth Court upheld a PUC disallowance of Pike purchased power costs from its parent company, Orange and Rockland Utilities on the grounds that the purchase had been imprudent. The state Supreme Court refused to hear an appeal.

The Pennsylvania commission and court decisions accepted that under the Narragansett Doctrine, FERC had sole jurisdiction to examine the *seller's* costs, and establish a fair wholesale rate for the sale of Orange & Rockland to Pike. Nevertheless, they reasoned, state regulators maintain the authority to rule that the *purchaser* was imprudent to buy power at those prices, because it could have obtained more economical sources of power elsewhere. The commission could then refuse to pass imprudently incurred costs through to retail ratepayers.

FERC itself has supported state authority to review the prudence of wholesale purchased power costs several times. In a 1981 Philadelphia Electric Co. case, FERC, approving a contract between utilities, noted:

> "[W]e wish to make it clear that our decision to accept the contract... does not, in our view, bind us or the Pennsylvania Public Utility Commission to any particular treatment of these items in the cost of service for wholesale and retail requirements customers of [the purchasers]....We do not mean by this order to prejudge, for our own purposes or those of respective state commissions, a determination of the prudence of either party entering into this transaction.[20]

In another case approving an Atlantic City Electric (AC) power purchase from Pennsylvania Power & Light (PP&L), FERC stated:

> "[We] wish to make clear that our decision to accept the agreement for filing is premised on the fact that the formula rate for this jurisdictional sale will not produce excessive revenues. Our decision is not, however, based on a determination that AC's purchase is prudent.[21]

In denying to rehear the case, FERC said:

> "We do not view our responsibilities under the Federal Power Act as including a determination that the purchaser has purchased wisely or has made the best deal available. However, these are legitimate concerns of the State commissions and this Commission as well in determining whether purchases reflect prudently incurred expenses for

> purposes of determining the purchase's rates for sales to others.

FERC has also reiterated the same position in at least two other cases.[22]

In Nantahala, the Supreme Court upheld FERC's exclusive authority over wholesale rates and power supply allocation contracts. In that case, the North Carolina Utilities Commission, in a decision upheld by the state Supreme Court, had disallowed purchased power costs in a FERC-approved contract allocating low-cost hydropower between two utility subsidiaries of the Alcoa Company. Instead, the commission allowed Nantahala Power & Light to charge its customers only as much as if it had prudently contracted for more low-cost hydro-power.

But the U.S. Supreme Court explicitly declined to take up the Pike exception to Narragansett, holding that the Nantahala case did not fall under that category:

> "Accordingly, the North Carolina Supreme Court erred in relying on cases treating the reasonableness of purchasing from a particular source of, rather than paying a particular rate for, FERC-approved power.... Without deciding this issue, we may assume that a particular quantity of power procured by a utility from a particular source could be deemed unreasonably excessive if lower-cost power is available elsewhere, even though the higher cost power actually purchased is obtained at a FERC-approved, and therefore reasonable, price.... But Nantahala's procurement of purchased power is not unreasonably large given that Nantahala could not have treated itself as having access to any more low-cost entitlement power than it is eligible to include under FERC's interpretation of what would be a fair allocation."

The Supreme Court decision not only leaves the legality of the Pike exception unclear in itself, it leaves a large blurry area in the interpretation of what constitutes a legitimate alternative source of less expensive power, particularly in view of the added complexities of the Grand Gulf case.

In Grand Gulf, for example, FERC not only reallocated the capacity of that plant among the Middle South Utilities (MSU) subsidiaries, but of all the nuclear plants on the MSU system. Though it chose not to, FERC could presumably have equalized generating costs throughout the MSU system. Moreover, FERC could presumably choose to extend similar authority over any power pooling arrangement. Under the Supreme Court's ruling, it is not clear whether a utility's own excess capacity, or excess capacity in a power pool in which the utility were a member, would constitute an alternative source of power in Pike County situation.

CONCLUSIONS AND RECOMMENDATIONS

It is essential that a new bright line be established between federal and state jurisdiction over utility regulation. Federal regulators should exclusively determine a fair price for power sold on the inter-state wholesale market that assures sellers the opportunity to recover reasonable costs from those who purchase bulk power. But when a company sells power intra-state to retail customers, state commissions should have exclusive authority to determine whether the seller has acted reasonably, and how much of its costs it can recover from retail customers.

Imagine a regulatory commission, if you will, not only ruling on a that a company has a right to charge a certain price for its product or service, but also trying to regulate how the purchaser should pay for it. Picture the outcry that would ensue if a regulatory agency tried to tell Consolidated Widgets not only that it had to pay a higher price for the regulated product, but how it should pay for the increase--whether by raising widget prices, or by taking it out of stockholder dividends. Whether the Jones family should pay for its rate increase out of its savings or checking account.

Yet that is exactly what FERC is attempting to do with Grand Gulf and other cases. FERC's responsibility should be examine the seller's costs and determine that the price it charges its customers are just and reasonable. The purchasing company has an obligation to pay the approved price, but whether it does so from its own profits, or by passing the charges on to someone else should be of no concern to FERC.

If the purchasing company happens to be regulated by a state utility commission, it is then that commission's duty to examine whether the firm has acted reasonably in its business decisions. If so, it may be entitled to pass costs on to its customers. If not, it must absorb them itself. But there are no conflicts of inter-state commerce because the wholesale purchaser is still obligated to pay the seller.

From a national economic perspective, it is also essential that responsibility for allocating the bulk of power plant construction costs and risks remain with state utility commissions.

Evaluating the prudence of utility construction is a very expensive task. A typical prudence investigation of a nuclear plant costs millions of dollars. It would be extremely burdensome for the Federal Energy Regulatory Commission staff to conduct many such investigations. Indeed, FERC made no prudence examination of Grand Gulf costs at all, whereas virtually every recent plant coming on-line has been the subject of extensive prudence investigation by state commissions.

State regulators are also in much better position to evaluate the numerous local factors that underlie the selection of the appropriate regulatory standards and their application: the accuracy of utility forecasts, adjustments to past over-forecasts, the viability of local alternatives to power plant construction, or the responsiveness of utility management.

Most importantly, state agencies are far better suited to weigh the potential risks and costs of future over-building or under-building of generating capacity. The economic climate and competitiveness of local business and industry will be heavily effected by utility investment decisions. State commissions have a much greater stake in the outcome and are more accountable to those who will ultimately pay the price of over- or under-investment.

Surely no one would favor the establishment of a national agency that would make all power plant construction decisions. Surely no one would favor guaranteeing that any utility investment would earn the same return regardless of how unneeded or expensive it turned out to be. Yet those are the conditions that would be created by a continuation of the trend of utilities building new power plants with generating company subsidiaries regulated exclusively by FERC.

The Ratepayer Protection Act would represent a major step forward in re-establishing the appropriate bright line between federal and state authority over utility regulation. We believe that S. 1149 would be even more effective, however, if it were not limited to associate companies of holding companies, to generating costs, and to cases where a state commission had not approved construction of the particular generating unit. Those restrictions unnecessarily weaken the protections the bill intends to offer.

First, while the most serious instances of federal pre-emption of state regulation have occurred thus far among companies in a holding company structure, this would not necessarily always be the case. FERC's logic in the Grand Gulf case could just as well be extended to any utility participating in a power pool--which includes virtually all utilities.

Setting up a generating subsidiary within a holding company structure is only one way that an enterprising utility could hope to skirt state regulation in favor of regulation by FERC. Purchasing bulk power from other utilities is an alternative available to any utility wanting to increase its supply options. Utilities could simply increase the amount of bulk power they sell to each other, and decrease the amount of power they generate for their own use. State regulators need the authority to determine the reasonableness of all supply decisions made by utilities selling to retail customers.

Second, there is no reason for limiting authority of state regulators to generation, but allow federal pre-emption over transmission and distribution, for example. FERC has also attempted to extend its authority over the allocation of transmission costs in a case involving a Kentucky utility, for example.

Third, authority to disallow costs should not be limited to states that had not approved the investment. State regulators should have the authority to evaluate power purchases with all the same standards--prudence, used and useful, and efficiency--used to evaluate other investments made by the utility to serve its customers. Even when a state has pre-approved the initiation of a particular construction project, that certification does not necessarily guarantee that the project would or should be fully included in the utility's rates.

The project may still be partially excluded for several reasons. Changed circumstances during the construction period might have led a prudent utility to reconsider the decision to complete the project. Management of project construction may not have been carried out in a prudent manner, or a minority partner's contracts may not have ensured prudent oversight of key decisions. And even if a project were judged to have been completely prudent, it may still not have turned out to be used and useful. State courts have recently upheld the authority of regulators to disallow not used and useful costs even when plant construction was certified by a state agency.[23]

Businesses operating in the competitive marketplace cannot recover investments that do not turn out to be productive, even if the decision to make the investment seemed prudent at the time it was made. State regulatory commissions should not be discouraged from requiring more of a marketplace-oriented sharing of unforeseen business risks between utility customers and investors.

NOTES

[1] "Consortium planning 2000 MW plant in NM steps up bid for power sales," Electric Utility Week, October 7, 1985, p. 7; "Alamito sets March 5 vote on leveraged buyout by management group," Electric Utility Week, February 17, 1986, p. 5; "SCE&G is 1985 Utility of the Year," Electric Light & Power, November 1985, p. 1; "A New Kind of Game for Electric Utilities", Public Utilities Fortnightly, July 11, 1985, p. 4.

[2] Jerry Pfeffer and William Lindsay, The Narragansett Doctrine: An Emerging Issue in Federal - State Electricity Regulation, National Regulatory Research Institute, Occasional Paper No. 8, December, 1984, p. 53

[3] See Nuclear Plant Cancellations: Causes, Costs, and Consequences, Energy Information Administration, DOE/EIA-0392, April 1983. Since that report, additional abandonments include Marble Hill 1 and 2, Midland 1 and 2, Zimmer, Hartsville A-1 and A-2, Yellow Creek 1 and 2, River Bend 2, Clinton 2, Skagit 1 and 2, Grand Gulf 2.

[4] From Rate Shock. The same estimate was also arrived at independently by Aaron Gurwitz and Daniel Chall, "Nuclear Power Plant Construction: Paying the Bill," FRBNY Quarterly Review, Summer 1984; also a Los Alamos study found that nuclear plants under construction would raise rates an average of 23 percent of 1983 levels, the same as the estimate made in Rate Shock. The annual overcharges can be expected to decrease over time, as the plants are depreciated, alternative fuel costs rise, and new capacity becomes needed. We have estimated that the lifecycle costs for the nuclear units under construction will exceed the costs of existing generation sources by about $200 billion in constant dollars. Charles Komanoff has calculated that the nuclear plants will cost about $65 billion more than new coal plants would have cost over their projected operating lives.

[5] The Future of Electric Power in America: Economic Supply for Economic Growth, Department of Energy, June 1983.

[6] "'Hair-curling shortages' or 'plenty of reserves'? What's the outlook?", Electrical Week, April 28, 1975.

[7] For example, Congressional Research Service, "A Perspective on Electric Utility Capacity Planning," 1983.

[8] Congressional Budget Office, "Financial Condition of the U.S. Electric Utility Industry," March 1986.

[9] For additional discussion of the prudence standard, see "The Prudent Investment Test in the 1980s," National Regulatory Research Institute, NRRI-84-16, April 1985.

[10] The used and useful standard actually predates the use of the prudence standard in utility law. It was first used by the U.S. Supreme Court in Smyth v Ames in 1898. See Roger Colton "Excess Capacity: Who Get the Charge From the Power Plant?" Hastings Law Journal, Vo. 23, No. 5/6, May/July 1983, p. 1133 and Commission Treatment of Overcapacity in the Electric

Utility Industry, National Regulatory Research Institute, NRRI-84-10, September 1984.

[11] National Economic Research Associates, "NERC Summary Load Forecasts: A Retrospective Appraisal and Technical Analysis," Electric Power Research Institute, EA-4355, December 1985.

[12] Energy Information Administration, "Nuclear Plant Cancellations: Causes , Costs, and Consequences", DOE/EIA-0392, April 1983.

[13] E.g., "N.J. Policy: Oust Plant From Rate Base if Cogeneration is Cheaper and Cleaner," *Electric Utility Week*, December 23, 1985, p. 1. Bill Paul, "Brokers May Shift Utility Recommendations to Reflect the Market Value of Power Plants," *Wall Street Journal*, March 3, 1986.

[14] Michael Small, "FERC Electric Rate Primer," *Energy Law Journal*, Vol 5, No. 1, 1984, p. 110.

[15] "FERC Tells High Court That State Regulation of Interstate Rates is Not Allowed," *Electric Utility Week*, February 10, 1986, p. 9. "AEP Challenges Kentucky PSC Order That Impedes FERC-Approved Pacts," *Electric Utility Week*, December 24, 1984, p. 1. (Case No. 9061); "W.Va. PSC Cannot Reject FERC-Approved AEP Transmission Line Deal, Says Judge", *Electric Utility Week*, March 4, 1985, p. 1; "FERC Rules on Prudence, Other Jurisdictional Issues in Holding Co. Cases," *Electric Utility Week*, September 16, 1985, p. 7.

[16] *Rhode Island Pub. Utilities Commission v Attleboro Steam & Electric Co.* (1927) 273 US 83, PUR1927B 348 (*Attleboro*)

[17] Carl Hobelman, "The Narragansett Decision and Its Aftermath," *Energy Law Journal*, Volume 6, No. 1, 1985, p. 33.

[18] Supreme Court of the United States, *Nantahala Power & Light Co. et al. v. Thornburg, Attorney General of North Carolina, et al.*, Opinion No. 85-568, June 17, 1986.

[19] *Pike County Light & Power Co.-Electric Division v Pennsylvania Pub. Utility Commission* (1983)-- Pa Cmwlth --, 465 A2d 735.

[20] *Philadelphia Electric Co.*, 15 FERC at 61,601 (1981).

[21] *Pennsylvania Power & Light*, 23 FERC P. 61,005 (1983).

[22] *Pacific Power & Light Co.*, 27 FERC P 61,080 (1984); *Kentucky Power Co.*, Docket No. ER84-579-001, Order Clarifying Prior Order, slip op. at 3 (Nov. 23, 1984).

[23] E.g., "State Court upholds Iowa-Illinois on tax issues, but not on excess capacity," *Electric Utility Week*, April 21, 1986, p. 11. Case No. 69076, in which the Iowa courts upheld a sharing of excess capacity costs from the Louisa plant between shareholders and ratepayers, even though the State Commerce Commission approved Louisa construction.

TABLE 1
ECONOMIC IMPACT STUDIES

MI	Detroit Ed	Fermi 2	35,000	jobs lost
MO	Union Elec KCP&L	Callaway) Wolf Creek)	40,000	jobs lost
NH	Public Serv.	Seabrook	19,000	jobs lost
NY	LILCO(a)	Shoreham	35-49,000	jobs lost
			37,000	families disqualified from mortgage market
			2,000	home foreclosures
			11,000	families pushed below poverty line
PA	Phila. Elec.	Limerick 1	19,000	jobs lost

Sources:
New York, New Hampshire: Greg Palast, Union Associates
Michigan: John Stutz, Energy Systems Research Group
Missouri: Robert Klepper
Pennsylvania: Arie Schinner, Wharton School of Economics

TABLE 2
PLANT CANCELLLATION TREATMENT BY STATES*
(Over $100 million sunk costs)

STATE	UTILITY	PLANT	COST (millions)	AMORT?	PERIOD (Years)	RETURN?
CT	United Illuminating	Seabrook 2	104	Full	10	No
IN	NIPSCO	Bailly 1	191	No(a)		
MA	Boston Edison	Pilgrim 2	278	Part	13(b)	Yes(b)
MI	Consumers Power	Marysville(c)	104	Part	10	No
		Midland 1 & 2	4000	(d)		
NJ	Jersey Central P&L	Forked River	395	Full	15	No
		TMI-2	184	Full	18	No
	Public Service E&G	Atlantic	301	Full	15	No
		Hope Creek 2	291	Full	15	No
NC	Carolina P&L	Harris 2	315	Full	10	No
		Harris 3 & 4	183	Full	10	No
	Duke Power	Cherokee	633	Full	10	No
	Virginia Elec & P	North Anna 3&4	626	Full	10	No
OH	Cincinnati G&E) Dayton P&L) Columbus & South.)	Zimmer	1700	No(e)		
OK	Public Service Ok.	Black Fox	251	Full	10	No(f)
	Portland GE	Pebble Springs	132	No		
		Skagit	138	Part	5	No
PA	Met Ed	TMI-2	369	Full	13.3	No
	Penn Elec	TMI-2	172	Full	8.7	No
SC	Carolina P&L	Harris 2,3,4	498	Full	10	No
	Duke Power	Cherokee	633	Full	10	No
TX	Houston L&P	Allens Creek 1	362	Part	10	No
		Allens Creek 2	12	Full	5	No
	Virginia Elec & P	North Anna 3,4	345	Full	15,10	No
WA	Puget Sound P&L	Skagit	178	Part	10	No

(a) NIPSCO was originally allowed by the PSC to amortize costs over 15 years. Decision was overturned recently by state Supreme Court, disallowing any recovery.

(b) DPU ruled that plant should have been cancelled in July 1980 and denied recover of costs from then until actual cancellation 15 months later as imprudent. Denied recovery of pre-cancellation equity carrying charges (AFUDC). Allowed return on remaining balance a 9.3 percent (cost of debt only).

(c) Coal plant.

(d) Midland case still unresolved. Company has received a $99 million "emergency" rate hike (equal to about 30 year amortization).

(e) Companies required to write off half ($861 million) of sunk costs. Remaining half will accrue finance charges and be used in conversion of unit to coal.

(f) Originally allowed return but subsequently disallowed and refunded.

*No FERC-jurisdictional costs over $100 million.

Sources: Energy Information Administration, supplemented with trade press reports.

TABLE 3
MAJOR DISALLOWANCES

STATE	UTILITY	PLANT	COST/ UTILITY (millions)	DISALLOWED FROM RATE BASE (millions)	REASON
AR	Arkansas P&L	Grand Gulf	1260	151	Settlement (a)
CA	Pacific G&E	Diablo Canyon 1,2	5400	1000 (b)	Imprudence
	Southern Cal Ed	San Onofre 2,3	4500	536 (c)	Imprudence
				450 (c)	"Unreasonable risks
IL	Commonwealth Ed	Byron	2100	101.5	Imprudence
KS	Kansas G&E	Wolf Creek	1300	142.5	Imprudence (d)
	Kansas City P&L			741.4	Excess capacity
				235.9	Revaluation
LA	Louisiana P&L	Waterford 3	2840	284	Imprudence settlement
		Grand Gulf	972	175	Settlement (e)
MI	Detroit Edison	Fermi 2	3075	294.3(f)	Imprudence
MO	Union Electric	Callaway	2800	384	Imprudence
NY	Long Island Lighting	Shoreham	4500	1350	Imprudence
PA	Pennsylvania P&L	Susquehanna 2	3000	No return on equity	Excess capacity
	Philadelphia Elec.	Limerick 1	3800	1600 (g)	Imprudence
TX	Houston L&P et. al.	South Texas 1,2	5500	1800	Imprudence

(a) The Arkansas Grand Gulf settlement calls for Arkansas P&L shareholders to absorb 12 percent of Grand Gulf costs initially, rising to 22 percent over 10 years. The settlement is not really equivalent to a full imprudence disallowance, however, since the company can sell its retained share on the wholesale market and retain any revenues from the sale.

(b) Recommended by Attorney General.

(c) Recommended by PUC staff

(d) Disallowances applicable to each utility.

(e) Settlement calls for Louisiana P&L to absorb 18 percent of costs. Same stipulation as above on sales.

(f) Recommended by Administrative Law Judge.

(g) Recommended by PUC staff.

(h) Recommended by PUC audit. Includes direct costs only, no carrying charges.

FERC gets highest marks in PSC performance ratings

State regulators allowed only $1.2-billion in rate relief in the first half of 1985. This is the lowest amount granted since 1978, according to the latest Salomon Brothers' Inc semiannual review of electric utility regulators. However, the analysts expect a larger amount of rate relief in the second half of the year due to several pending cases involving completed nuclear plants.

The decrease "partially reflects the completion of construction programs and subsequent higher percentages of internally generated cash, which is a positive sign," says the review. "In part, however, decreases result from excess capacity and other disallowances being used as excuses to minimize rate increases." The analysts call these disallowances "a disturbing factor."

DECLINING RETURNS. While the allowed return on common equity for the first half of 1985 of 15.4% exceeded 1984's level, it has been declining from 15.7% during the fourth quarter of 1984 to 15.5% and 15.4% during the first and second quarters of 1985, says the review. This reduction "primarily reflects decreased return on equity."

In addition, a return to normal weather, less rate relief, and the substitution of plants in service for AFUDC have caused earned returns on equity to fall faster than allowed returns. Earned returns on equity have dropped from 15.4% for the 12 months ending June 30, 1984, to 14.7% for full year 1984, to 14.3% for the 12 months ending June 30, 1985, according to the review.

Salomon Bros and two other investment brokerage firms, Merrill Lynch Capital Markets, and Duff and Phelps, continually rank the regulatory commissions to help investors judge performance of regulatory environments (see table). No commissions were placed in the highest category by any of the investment firms. FERC was the only regulatory agency included in the second highest category by all three firms. When ranking commissions, the investment houses consider such factors as allowed return on equity and rate base, the inclusion of CWIP in rate base without an AFUDC offset, the test period, type of rate base, accounting permitted, existence of fuel clauses, the speed with which new rates are granted, and the existence of interim rates. ■

How commissions rate with analysts

	DP	ML	SB
Alabama	IV	1	C−
Arizona	IV	2+	C−
Arkansas	*V*	1+	*C−*
California	IV	3+	B
Colorado	IV	2	C
Connecticut	IV	4−	B
Delaware	III	3+	C+
Washington, DC	V	2+	D
Florida	III	4−	B
Georgia	IV	3−	C−
Hawaii	IV	3	*C*
Idaho	V	3−	C−
Illinois	III	4+	B
Indiana	II	3	C+
Iowa	IV	2	C−
Kansas	IV	2	C
Kentucky	III	3+	C
Louisiana	VI	1	E
Maine	V	1	D+
Maryland	IV	2+	C
Massachusetts	V	2+	C
Michigan	VI	2−	D
Minnesota	IV	4−	C+
Mississippi	IV	1	D
Missouri	V	3−	C−
Montana	VI	1	E
Nebraska	—	2−	—
Nevada	V	3	C
New Hampshire	IV	2+	C−
New Jersey	III	3	C+
New Mexico	II	3	C+
New York	IV	3+	C+
North Carolina	IV	3	C+
North Dakota	V	2	C−
Ohio	IV	3−	D+
Oklahoma	IV	3	C+
Oregon	III	4−	B
Pennsylvania	V	3	*D+*
Rhode Island	III	2	C−
South Carolina	IV	3	C−
South Dakota	V	2−	D
Tennessee	—	2	—
Texas	III	3	B
Utah	II	3+	B
Vermont	IV	4−	C+
Virginia	IV	3	C−
Washington	V	3	C
West Virginia	V	2−	D
Wisconsin	III	4	B
Wyoming	V	1	C−
FERC	II	5	B

Notes:
DP - Duff & Phelps - I is the highest rating, VI is lowest
ML - Merrill Lynch - 5 is highest rating, 1 is lowest
SB - Salomon Bros - A is highest rating, E is lowest
Bold indicates upgrade, italic indicates downgrade

Senator Bumpers. Thank you very much, Mr. Nogee.
Mr. Hutchinson.

STATEMENT OF ASA HUTCHINSON, FORT SMITH, AR

Mr. Hutchinson. Thank you, Mr. Chairman.

As an Arkansas taxpayer and utility ratepayer, I want to thank Senator Pryor and Senator Bumpers for introducing and sponsoring the Ratepayer Protection Act of 1985. I also appreciate the generosity of this committee for permitting me to testify concerning this proposed legislation, which is of great importance not only to the people of Arkansas but for every consumer of electric power in the United States.

As this committee is well aware and as demonstrated by the powerful testimony given today, Arkansas ratepayers are extremely concerned and distraught about the prospects of paying for another powerplant known as Grand Gulf II.

I am here today, Senator Bumpers, to support the Ratepayer Protection Act of 1985. I also want to suggest ways to make this effort even more effective in insuring affordable energy to consumers while keeping our utilities on sound financial footing.

In the last 10 years, AP&L has entered into construction of two nuclear plants and two coal plants. Simply put, the second coal-fired plant made electricity from the Grand Gulf plant unnecessary. There are many more details to this story, but it is important to also look at other elements of the energy scenario during this 10-year period.

First and foremost was the change of the regulatory environment for electric utilities. The Government began to mandate elements of production as never before, unnecessary natural gas price regulations were prolonged, and the Fuel Use Act told utilities what fuel they must burn.

Federal energy policy was awash in contradictions and competing regulations and agencies. As usual, the consumer was caught in the middle, paying for both management error and the overzealousness of Government officials.

As stated by a Democratic colleague of yours in the Senate, Bennett Johnston, we have built a regulatory system designed by lawyers for lawyers that produces only delays and legal fees that ill serve the public.

I believe the overall goal of future policy should be a return to a more market-oriented approach to electricity production and supply. That is why I support the Ratepayer Protection Act of 1985, since it attempts to interject greater risk in utility management decisions.

The Ratepayer Protection Act basically says to management of the utility company that unless you get permission in advance from the public utility commission to construct a powerplant, then you cannot be assured that the related costs will be assigned to ratepayers. I believe this proposal is reasonable, it is proper, and it is workable.

I believe that I could suggest, though, that this legislation be amended to specifically outline the responsibilities of the FERC in cases of abandoned powerplant construction projects, and as we know we are talking about Grand Gulf II in particular as well as other similar projects that might come down the pike.

We have all talked about FERC today. The key issue in determining the proper allocation of costs between stockholders and ratepayers when there is a financial loss is the prudence of management decisions.

I would propose the Ratepayer Protection Act be amended to provide as follows: First of all, in cases of abandoned powerplant projects which come before FERC for cost allocation, the FERC would be required to hear facts and determine whether or not management acted prudently; and second, that there would be a presumption that the costs of an abandoned plant not be passed on to ratepayers unless the FERC determines that management acted with good judgment. If a management error was responsible for financial loss, then the stockholders should be made to bear the burden.

Ratepayers would bear costs directly attributable to their requirements for service, which would be factors such as fuel costs, labor costs and the costs of new facilities, should demand increase and a new plant be warranted. The FERC would merely rule on the cause of the financial burden, management or uncontrollable, and then assign costs accordingly. This allows both management and consumer advocate alike to argue their cases, and it sets a pro-consumer standard of review in the event of appeal.

From a broader prospective, the Grand Gulf fiasco gives us ample evidence to reflect on our overall energy picture for the future and what course of action would be pursued.

No. 1, we must deregulate all possible energy sources, especially natural gas. The more energy options that are available the more likely the consumer will be to get a fair deal and a steady power supply.

Prior to the energy scare of the early 1970's, Arkansas Power and Light depended heavily on natural gas to produce 98 percent of the electricity it generated, but today that figure stands at just 3 percent.

With gas prices dropping due to plentiful supplies, just think of the savings to consumers if the Government would end its burdensome price restrictions and allow utilities to choose their own fuel.

We must build a stable regulatory environment for the suppliers of electricity to operate in. If they make an error, then they should pay, so we owe it to them to keep the playing field level.

Arkansas could be on the verge of tremendous growth if we only could straighten out this issue and allow the market forces to simply work themselves out. In fact, demand for AP&L electricity is going at a 3 percent annual rate, which is above the national average. If you contrast this to prior to the crisis of 1973 and 1974, it was running at an annual pace of approximately seven to 10 percent a year.

Grand Gulf is a sympton of an ill-conceived energy policy. We are now faced with not only curing the symptom but eradicating the disease entirely. As for the sympton, this Act is a step in that direction. With the suggestions which I have proposed and strong bipartisan support, this is good medicine that will go a long way to alleviate anxiety the people of Arkansas deeply feel.

That is only the short-term remedy, and then we can talk about the disease itself. The United States has had a rough time in the energy market in the past decade, but our own policies are as much to blame as anything, as this hearing has particularly demonstrated.

These are the reasons why I support the Ratepayer Protection Act of 1985, and I am grateful for this opportunity to testify and give my support for this legislation.

Thank you very much.

[The prepared statement of Mr. Hutchinson follows:]

PREPARED STATEMENT OF ASA HUTCHINSON

Mr. Chairman. As an Arkansas taxpayer and utility ratepayer, I want to thank Sen. Pryor and Sen. Bumpers for introducing and sponsoring the Ratepayer Protection Act of 1985. I also appreciate the generosity of this committee for permitting me to testify concerning this proposed legislation, which is of great importance not only to the people of Arkansas, but for every consumer of electric power in the United States.

I am a lifelong resident of the state of Arkansas, and I have followed the saga of the Grand Gulf power plant from its beginning. As this committee is well aware, Arkansas ratepayers are extremely concerned and distraught about the prospects of paying for another power plant known as Grand Gulf II.

I am here today to support the "Ratepayer Protection Act of 1985." I also want to suggest ways to make this effort even more effective in ensuring affordable energy for consumers while keeping our utilities on sound financial footing.

Arkansas Power and Light has cooperated well with its three sister companies for 30 years, selling excess power when demand fell and buying more when capacity was short. Those were the days when market forces, not government regulators, dictated fuel mixes for utilities. Future demand had to be predicted, but the whims of a federal bureaucrat never had to be factored into the projections.

In the last ten years, AP&L has entered into the construction of two nuclear plants and two coal plants. Simply put, the second coal-fired plant made the electricity from the Grand Gulf plant unnecessary. AP&L was released from the Grand Gulf commitment, and all was fine until the Federal Energy Regulatory Commission ruled that AP&L would be required to pay for Grand Gulf costs after all.

There are many more details to the story, but it's important to also look at other elements of the energy scenario during this ten-year period.

First and foremost was the change of the regulatory environment for electric utilities. The government began to mandate elements of production as never before. Unnecessary natural gas price regulations were prolonged and the Fuel Use Act told utilities what fuel they must burn.

In addition, nuclear power was hit with a moratorium, raising capital costs. Stricter regulations requiring expensive retrofitting of nuclear plants were promulgated. An aggressive Nuclear Regulatory Commission became more interested in stopping all nuclear power than making it safe and affordable.

Federal energy policy was awash in contradictions and competing regulations and agencies. As usual, the consumer was caught in the middle, paying for both management error and the overzealousness of government officials. As stated by your Senate colleague, Bennett Johnston, "We have built a regulatory system designed by lawyers, for lawyers, that produces only delays and legal fees that ill serves the public. That is the original sin," behind the Grand Gulf controversy.

I believe the overall goal of future policy should be a return to a more market-oriented approach to electricity production and supply. That's why I support the "Ratepayer Protection Act of 1985," since it attempts to interject greater risk in utility management decisions. Risk is a natural ingredient of the market process. However, I don't believe the bill goes far enough with this idea.

The Ratepayer Protection Act basically says to the management of the utility company that unless you get permission in advance from the public utility commission, which has jurisdiction over each of your associate companies participating in power plant construction, then you cannot be assured that the related costs will be assigned to ratepayers. I believe this proposal is reasonable, proper, and workable. However, I would suggest this legislation be amended to outline the responsibilities of the FERC in cases of abandoned power plant construction projects.

The key issue in determining the proper allocation of costs between stockholders and ratepayers when there is financial loss is the prudence of management decisions.

I would propose the Ratepayer Protection Act be amended to provide as follows: 1) In cases of abandoned power plant projects which come before the FERC for cost allocation, the FERC would be required to hear the facts and determine whether or not management acted prudently, and 2) there would be a presumption that the cost of an abandoned pleant not be passed onto ratepayers unless the FERC determines that management acted with good judgment.

If a management error is responsible for a financial loss, then the stockholders should be made to bear the burden. Ratepayers would bear costs directly attributable to their requirements for service, which would be factors such as fuel costs, labor costs, and the costs of new facilities should a new plant be warranted by increased energy needs.

The FERC would merely rule on the cause of the financial burden, management or uncontrollable, and then assign costs accordingly. This allows both management and consumer advocate alike to argue their cases, and it sets a proconsumer standard of review in the event of appeal.

The Grand Gulf fiasco gives us ample evidence to reflect on our overall future energy picture and what course of action we ought to pursue.

Number one, we must deregulate all possible energy sources, especially natural gas. The more energy options that are available, the more likely the consumer will be to get a fair deal and a steady power supply.

Prior to the energy scare of the early seventies, Arkansas Power and Light depended on natural gas to produce 98-percent of the electricity it generated. But today, that figure stands at just three percent. With gas prices dropping due to plentiful supplies, just think of the savings to consumers if the government would end its burdensome price restrictions and encourage utilities to burn more gas. The Secretary of Energy, John Herrington, estimates natural gas prices would fall fifteen percent in the first year of deregulation alone.

Secondly, we must stop wasting billions of dollars on pie-in-the-sky projects like the Synthetic Fuels Corporation. If there are legitimate alternative sources, the market will find them much more quickly and cheaply than will the federal government.

Lastly, we must build a stable regulatory environment for the suppliers of electricity to operate in. If they make an error, then they should pay. But we owe it to them to keep the playing field level.

Arkansas could be on the verge of tremendous growth if only we could straighten out this issue and allow the market forces to simply work themselves out. In fact, demand for AP&L electricity is growing at a three percent annual pace which is above the national average. While that news is promising, the fact remains that demand was increasing between seven and ten percent a year prior to the energy crisis of 1973 and '74.

AP&L says rates should stabilize and Arkansas is past the recent "rate shocks." That is a very attractive selling point for economic development in my state, but it won't happen as long as Grand Gulf hangs over our heads.

I think we all agree that our goal must be to work toward the most economical electric rates possible for consumers. But that means government policy should help, and not hinder our power companies in developing and using the least expensive energy sources.

Grand Gulf is a symptom of an ill-conceived energy policy. We are now faced with not only curing the symptom, but eradicating the disease entirely.

As for the symptom, the Ratepayer Protection Act is a step in the right direction. With some improvement and strong bipartisan support, this is good medicine that will go a long way to alleviate the anxiety that the people of Arkansas now feel. But that's only the short term.

What about the disease itself? The U.S. has had a rough time in the energy markets in the past decade, but our own policies are as much to blame as anything. As I recently stated in the Arkansas Gazette, the best thing we can do for consumers and producers alike is to let 'em produce, let 'em sell, and get out of their way.

Senator BUMPERS. Thank you, Mr. Hutchinson.

General Clark, has the National Attorney Generals Association taken a position on this legislation?

Mr. CLARK. Senator, we have discussed this at a couple of our meetings. As you know, I am the national president of the organization, and it is on our agenda for our December meeting.

Senator BUMPERS. If they have not, I assume you will arrange that they will.

Mr. CLARK. I am going to work just on that. I will tell you that it came about as a result of a discussion initiated by Attorney General Skip Humphrey from Minnesota. As you pointed out in remarks, this is not an Arkansas problem. This is a national problem and one of national concern.

There is a pending resolution, and I bet we can get it adopted, Senator.

Senator BUMPERS. Good.

Mr. Hutchinson, when you say get out of their way, you are not talking about getting out of Middle South's way, are you, and letting them do what they want to?

Mr. HUTCHINSON. No. The legislation addresses a problem of the States' rights, and I think what I am suggesting is that we are pointing the problem at FERC, and we need to set some straight guidelines.

When I say get out of the way, I believe that the utilities should be able to direct their supply of energy and be able to obtain fuel to what is best for the market and best for the consumer. I believe this saves money in the long run, as I have mentioned in my testimony, particularly in natural gas.

Senator BUMPERS. Let me say that I certainly agree with you about the regulatory process. You cannot abolish all regulations in every field, obviously. One of the reasons we are here today, is it not, is because Middle South circumvented the regulatory process.

Do you agree with that statement?

Mr. HUTCHINSON. Well, I think they took advantage, obviously, by going to the FERC. The court decisions have not exactly helped in that area. They have strengthened the position of the FERC.

I would agree with the testimony thus far today that the authority of the State public service commissions have been diminished by the grabby nature of the FERC but also the court decisions that have supported them. That is why this returns a balance, as indicated by someone, a bright line, a true line between that authority.

Senator BUMPERS. I take it you agree essentially with Senator Pryor and me not only in favoring the legislation but that the States should not be preempted, as they have been by FERC, and given the kind of latitude that they have been given to rush to FERC and to avoid State regulation.

I assume you agree with that.

Mr. HUTCHINSON. That is the intent of this Act, and I would agree that the key thing is that they have to be responsible for management decisions. It is a level playing field by simply saying you have got to go to the State PSC first before you start entering into these agreements and engage in these projects. That protects the States and gives them input into it and gives a balance in the authority of FERC as related to the State PSC.

Senator BUMPERS. Now, you seem to be primarily concerned with Grand Gulf II in your statement. Do you agree with the retroactivity part of our bill dealing with Grand Gulf I?

Mr. HUTCHINSON. First of all, that is exactly the thrust of my testimony pertaining to Grand Gulf II. With the settlement that has been entered into at the State level for Grand Gulf I and I believe the appeal that is before the D.C. Circuit, hopefully that will give some relief.

I have not particularly looked into the retroactive provisions. I, quite frankly, would question whether that would be able to, first of all, be passed by this committee but also I would have some concern about the constitutional provision of that.

Senator BUMPERS. If it could be passed, would you agree that it should be?

Mr. HUTCHINSON. Absolutely. If there is a way and it can be done by legislation or by overturning the FERC decision, 100 percent we have to have that overturned for the benefit of Arkansas ratepayers. So, certainly, if we can get that retroactive provision in there, that is good for Arkansas.

Senator BUMPERS. I think you heard me say in my opening argument there is no pride of authorship here. Anything we can do to improve this bill, to make it better to accomplish the purpose which we are trying to accomplish, we are going to work on the bill ourselves some to possibly strengthen it and would welcome any other suggestions.

Do you have your amendment, incidentally, prepared?

Mr. HUTCHINSON. No, Senator Bumpers, I have made the suggestion in broad outline form. I know that your committee staff, if they find that this would be appropriate and beneficial, could draft it accordingly.

Senator BUMPERS. Let me ask you this question, and that is under our bill, so far as an abandoned plant is concerned, if they have not secured State approval of construction under this legislation and they wind up with an abandoned plant, the Arkansas Public Service Commission will not be obligated to pass on any part of or all of the cost of that abandoned plant.

Now, it seems to me that your amendment says you change the presumption, the existing presumption, that an abandoned plant was prudently started. You change the presumption to say that it was imprudently started, but you make that a rebuttable presumption.

In short, you give the authority back to FERC, and I am wondering if that really is your position, to give FERC the authority to determine whether we are going to pay for an abandoned plant rather than the State regulatory——

Mr. HUTCHINSON. I do not believe this is giving authority back to FERC. FERC already has the authority.

Senator BUMPERS. But they would not have the authority if our bill passes.

Mr. HUTCHINSON. They already have the authority to look into the prudency question of management decisions. The problem is they are not doing it right now, and this would mandate them to do that.

Your legislation would certainly say you have got to get permission in advance. That is good. I think that is important, but I think you can add a second leg to this legislation to also say that when it does come before FERC in setting wholesale rates of electricity that they have to look at that issue of prudency in management decisions.

Regardless of whether they come to the State first or not, the FERC is still going to be involved in setting the wholesale rates of electricity. That is going to happen, so they need to be looking at this as well.

Senator BUMPERS. Do you know how many times FERC has ever ruled that a plant was imprudent when it started, an abandoned plant?

Mr. HUTCHINSON. I am not sure they have ruled on that issue at all.

Senator Bumpers: Well, I think they have, and I think that they view abandoned plants like they do utility companies. They never saw an abandoned plant they did not like.

I would be most reluctant, even though you require the hearing before FERC. They have never, in my opinion, disallowed one dime as a result of an imprudent decision on the part of a utility company, and that is one of the reasons we want to give that authority back to the State and not leave it with FERC.

Mr. HUTCHINSON. They have not done it. How many times have they ruled on that issue? They have not done it because they have not been looking into that issue, first of all.

Second, that is exactly why you would need this presumption there; that the ratepayer has a leg up on it, has an advantage going in. It is a proconsumer approach that in the case of an abandoned plant, in the case of Grand Gulf II, the presumption is that the stockholder rather than the ratepayer should absorb this cost.

Senator BUMPERS. So you trust FERC to do the right thing if you mandate that they look into it, to come to the right conclusion?

Mr. HUTCHINSON. It is not a matter of trusting FERC. It is a matter of making them do their job and then giving a good standard of review for appeal.

Senator BUMPERS. Senator Pryor.

Senator PRYOR. Senator Bumpers, I am not a member of this committee, and you all have been nice enough to let me sit up here with you this afternoon. I appreciate that, but I think you do have a real live sitting member of the committee here, Senator Rockefeller. Maybe he would like——

Senator BUMPERS. Well, he is alive. That is all I can vouch for.

Senator PRYOR. I bet he would like to say something or ask some questions. Then when you two committee members finish, I will maybe ask one or two.

Senator ROCKEFELLER. You are a stickler for protocol, Senator.

I am very interested in the bill which Senator Bumpers has been fighting for. I serve not only on this committee but also on the Commerce Committee, and there is a very interesting parallel, it seems to me, with respect to the question about FERC and the Interstate Commerce Commission.

The Interstate Commerce Commission, as you very well know, Mr. Hutchinson, and others obviously know, is charged with keeping railroad rates reasonably in line by law, but they do not. We in the Congress have spent an awful long time trying to get them to do what they ought to be doing, but they do not. The Interstate Commerce Commission has never found a railroad to be revenue adequate. Railroads are poor as far as the Interstate Commerce Commission is concerned.

So I think that in the more hardboard realism of how it is that government really works, we have to change the law to make sure that they do not just exercise what it is that we would like them to do but we make them do it precisely. They have never met a railroad they did not like and which they found to be anything other than poor.

The taxpayers have been ripped off with regard to coal in our parts of the country and agriculture, I presume, in other parts of the country. The taxpayers have been ripped off by railroads for years.

It would seem to me, Mr. Chairman, looking at this amendment which Mr. Hutchinson has put forward, that he is asking FERC, which I look upon as I do the Interstate Commerce Commission, as I read it, to be required to hear the facts and determine whether or not management acted prudently. Well, one can look at several tests—just and reasonableness, prudency * * * one can look at used and useful.

Then he says the second part would be there would be a presumption that the cost of an abandoned plant not be passed on to ratepayers unless the FERC determines that management acted with good judgment.

Now, in the hard world of government if I were structuring that, I would never give FERC the room to make that judgment because I can predict exactly what judgment they will make, and the cost will go right on to the taxpayers of the various States that are involved here.

I really wonder, Mr. Hutchinson, whether in this rebuttable presumption that your suggested amendment creates, you really do believe that FERC would come through in the manner that you would hope that they would. Is that a safe kind of thing to put into legislation in the hard business of government?

Mr. HUTCHINSON. I do not think I am being too optimistic about the regulators based upon their past performance, but this a two-pronged approach.

First of all, anytime they come into FERC for a rate increase based upon an abandoned powerplant, and that is the narrow instance of which we are speaking, under the legislation which Senator Bumpers has proposed they would already have gone to the State for authority, so the State would be having the input. They would be making the decision as to whether an associate company of a holding company can participate in this.

So this is the second prong that, in addition, when they come into the FERC and say we had permission to start this but now we want to abandon it, and they want to pass that $1 billion in costs along to the ratepayers, then FERC would have that presumption that no, it must be passed to the stockholders and you have to show us that this decision is prudent.

Senator **Rockefeller**. Do you believe that FERC would do that, would do anything other than rule for the utility? Do you think there is really any chance that they would do anything other than rule with the utility? I do not.

If this is an amendment that you are asking me, as a member of the Energy Committee, to look at, I have to have some reason why you would have that confidence.

Mr. **Hutchinson**. I am presenting this to you because I believe that the duty of this subcommittee and the duty of Congress is to make FERC do their job. You are the oversight committee for FERC, and I know that this is the purpose of this hearing. I commend you for what you are doing in this hearing.

This is one area which I believe they have not been exercising their authority. They have not been examining the prudency of management decisions. I believe that this is a method by which they would be mandate to do that.

I would like to think that they have the good sense and a sense of justice to carry out that mandate which Congress gives them. That is exactly the reason there is a presumption in this case, that if they do not do that there is a standard of review that is pro-consumer for which it can go to the Court of Appeals and they can rule upon that. They have a good basis of facts. They have a hearing in which they can determine and review the record.

Senator **Rockefeller**. I understand what you are saying. I guess I just feel that if I were writing that amendment, I would not give the latitude to FERC that I think that you appear to in this amendment. I would think that on the Energy Committee where we would look at this, we might be a little harder and more restrictive on FERC.

Let me ask one more question, Mr. Chairman, and I do not mean to take up your time.

Mr. Hutchinson, let me ask you this. Do you think that we on the Energy Committee and then in the Senate as a whole should vote against any nominee to FERC who does not repudiate the FERC decision that has been discussed here?

Mr. **Hutchinson**. You know, whenever you ask that question I sort of have to think back to the process of the Senate on judicial nominees as a whole, and it is a quasi-judicial body, obviously. That is asking them to take a position on a particular case that may be coming before them, so I think it is a somewhat tough question.

From an Arkansas standpoint, that is certainly the right question to ask. That is what I would want to find out from your perspective as to their view on that.

Now, they have the *Narragansett* decision and some others which support what they have been doing. I think that is one direction to go, to severely question the nominees. Second, I think the Ratepayer Protection Act is important to narrow the authority of the FERC and return some of the authority to the States.

Let me just emphasize again, if I may, Senator Rockefeller, that I do support the Ratepayer Protection Act, and that is the reason for my presence here today.

Senator **Rockefeller**. Thank you, Mr. Chairman.

Senator **Bumpers**. Senator Pryor.

Senator **Pryor**. Thank you, Mr. Chairman.

I, also, would just like to comment, Mr. Hutchinson, on the amendment as I understand it. I have not seen a copy of it, but I sense that you may be, probably unintentionally, expanding the role of FERC rather than trying to cut it down some.

I think we ought to all get together and, frankly, figure out a way to cut back some of their prerogatives and decisionmaking authority. I agree with our friend to your right, there, Mr. Nogee. I just truly believe that we are being preempted so quickly in this whole area of utility regulations by the Federal Energy Regulatory Commission.

I want to express to you as one fellow citizen to another how grateful I am that you came up to Washington today. Senator Bumpers and I and the delegation up here have been working for about, I guess, 2 or 2½ years on this. We have filed appeals, and we have done truly about everything legally we know how to do.

Now we are going to need some help. We are going to need some help with maybe even a higher power than the Federal Energy Regulatory Commission, and I think you know who I am talking about, the man that appointed them.

Mr. Hutchinson, I am going to ask you this question. Have you called the President and asked him for his support in helping the Arkansas ratepayers overcome this FERC decision?

Mr. **Hutchinson**. I an not sure what influence President Reagan has over the administrative law judges and the commissioners after they are appointed. It is a quasi-judicial body, but I will assure you this. If there ever becomes a vacancy on there, I will immediately contact the President and ask him to appoint someone who has a greater respect for State rights.

Senator **Pryor**. Would you go even a step further? Would you try to contact the President while you are in town and maybe get his advice or help on this matter, and tell him about the plight of our ratepayers in Arkansas? I understand this is a quick trip for you.

Mr. **Hutchinson**. I thank you for thinking that I have such powers and influence over the President.

Senator **Rockefeller**. Well, I hear that you are pretty close and want to get closer. I am just cutting up with you a little bit. It is late in the afternoon.

Mr. **Hutchinson**. Well, that would be a good excuse for me to go see the President. I will see if I can arrange that.

Senator **Pryor**. Well, we hope you will help us on that, because sometimes Senators Rockefeller, Bumpers, and Pryor cannot seem to get in down there too often. We hope that you will go to bat for the ratepayers in whatever capacity in which you serve, and we do appreciate your coming.

Mr. **Hutchinson**. Thank you, Senator Pryor.

Senator **Bumpers**. Mr. Nogee, how many prudency tests has FERC conducted, and how many of those prudency tests have resulted in the denial of any rate request?

Mr. **Nogee**. There was a speech by a FERC administrative law judge a couple of years ago in which he mentioned that there were hundreds of times where FERC was asked to make findings of imprudence, but they had not in any of them, except for one natural gas transmission case.

I think there are a couple of very minor electric utility cases where FERC did not overrule imprudence findings by State commissions; however, those were quite a while ago.

There is also a recent decision in which FERC held that a Massachusetts utility company was not imprudent in a plant abandonment case, overruling, in fact, the Massachusetts Department of Public Utilities finding that the company had been imprudent. That was a serious setback.

Basically, FERC has declined to find any imprudence on the part of any utilities.

Senator **Bumpers**. Well, they have in the past allowed the recovery of the cost of an abandoned plant but not a return on the costs. They have ruled that, in every instance as far as I know, the utility company gets their costs back but not a return on investment.

Now, they have this NEPCO, New England Power, case pending in which they are holding hearings on whether or not they should go further and allow a return on the costs so that the ratepayers not only would have to pay, say, in Grand Gulf II for $1 billion worth of uncompleted plant, but a return on that $1 billion. Is that not correct?

Mr. **Nogee**. Yes, that is correct, and that would be a major step backward from their own practices as well as the practices of virtually every State commission.

It should also be mentioned that even when they have not allowed a return on those costs but just the return of the costs, FERC has generally allowed a return of the cost over 5 to 10 years, whereas with most State commissions the average period of return on those costs is about 10 years.

That puts a much bigger burden on the shareholders than FERC's policy so, even there, FERC has been more generous to investors than virtually every State regulatory commission.

Senator **Bumpers**. Thank you very much.

Mr. Hutchinson.

Mr. **Hutchinson**. Since Senator Pryor has stepped out, maybe you can pass this along to him based upon his comments about me and the President. I will be meeting with the Secretary of Energy tomorrow, and I do intend to raise this entire issue with him and not only speak to him about the Grand Gulf issue, but I know that in Arkansas we have to start looking at the long-term picture of utility rates and what can be done in that area.

Thank you, Senator.

Senator **Bumpers**. Tell him I would appreciate his support. If you see the President, tell him we are desperate for his support for this bill.

General Clark.

Mr. **Clark**. To respond to you and Senator Rockefeller, I was not aware of the amendment that was being proposed or offered by Mr. Hutchinson until I arrived here today. I would like to check my information to supplement this for the record, but I do have one concern about that amendment.

I do not trust the FERC either, Senator Rockefeller, but that is not my principal concern. My principal concern is, as I understand the amendment as it is drafted, it would permit the recovery of 100 percent of the cost if good or prudent judgment was found to have existed at the time.

I think current FERC policy is that only 75 percent of that investment can be recovered even if prudent, and in the NEPCO case I think the position being recommended by the staff of FERC is 50 percent. So this amendment seems to go further in terms of not giving a limitation, at least, even if the judgment is prudent in the decision.

Senator BUMPERS. General Clark, I can tell you, I welcome the suggestion, but certainly I am not for reposing this authority in FERC. I want to do exactly what we intended to do, and that is to give it back to the State of Arkansas and the other States.

Mr. CLARK. We are glad to hear that, Senator.

Senator BUMPERS. Thank you all very much for coming.

Our third panel is Dr. John Mayo, assistant professor of economics from the University of Tennessee; Dr. Dick Schuler, professor of economics from Cornell; and Dr. Roger Sherman, chairman of the department of economics from the University of Virginia.

Professor Mayo, would you lead off, please?

STATEMENT OF DR. JOHN W. MAYO, ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF TENNESSEE

Dr. MAYO. Good afternoon. My name is John Mayo. I am an Assistant Professor of Economics at the University of Tennessee in Knoxville. My field of specialization is industrial organization, which includes areas of antitrust economics and the economics of regulated industry.

Today I would first like to tell you what a genuine pleasure it is for me to be here to speak to you about a matter of what I consider to be of significant importance, the development of sound public policy toward the electric utility industry.

I have a prepared statement for the record that I hope you have an opportunity——

Senator BUMPERS. It will be submitted for the record, John.

Dr. MAYO. Thank you. I hope you have an opportunity to read it, but in the interest of brevity today what I would like to do is simply provide a few highlights from that written statement.

I think there are currently facing the electric utility industry a number of very important public policy questions. These involve questions of risk sharing, prudency, construction work in progress, diversification, deregulation, and so on.

Now, I do not think it has ever been the role of Congress in general or this committee in particular to resolve each and every one of those regulatory issues that come before the public. Regulatory issues such as the ones that I have just mentioned have most typically been resolved by regulatory rather than legislative bodies.

It is, however, the responsibility of Congress to establish the broad regulatory parameters within which the States can most effectively accomplish their task of insuring the efficient and equitable provision of electricity to their consumers.

With that perspective in mind, my written testimony has two components. First, I discuss the economic complications of the current regulatory policy in the electric utility industry. Second, I describe how this perspective on the economics of electric utility regulation sheds light on the specific merits of S. 1149.

Ideally, rate of return regulation permits the most efficient industry structure for the provision of electricity, that is, a single firm within a given market area, but also prevents the excesses typically associated with monopoly supply.

Now, against this ideal a number of shortcomings in the way modern day regulation has been practiced have emerged. Some industry observers have called attention to these shortcomings of regulation and distortions in regulated firm behavior and have argued that deregulation of the electric utility industry would eliminate these costs.

For reasons that I have described in my written testimony, I think the case for outright deregulation of the electric utility industry is far from clear, but to decide against a policy of outright deregulation of the industry does not mean that policymakers should ignore the fundamental lessons of competitive markets.

A standard goal of regulation should be to allocate resources in a fashion similar to that which would prevail under competition if, in fact, competition were viable. For instance, a fundamental lesson from the operation of competitive markets is that profits from innovative behavior and losses from incorrect managerial decisions will provide the maximum incentive for efficient firm behavior.

The importance of heightening these managerial incentives for cost minimization in this industry should not be minimized. To date, some costs in cancelled nuclear power plants that will never produce a single kilowatt hour of electricity amount to $18 billion. Simply put, increased industry efficiency cannot reasonably be expected until those responsible for the efficient provision of electricity are held accountable for their actions.

Another necessary step of regulation is the need to coordinate and, to the extent possible, align the interests of the various regulatory bodies. This requires some element of commonality between approaches taken at the Federal level, in this case FERC, and the State level with the State public utility commissions.

Unfortunately, however, there has emerged a widening disparity between the approaches taken at these levels. Exemplary of this disparity are the differential treatments of power plant construction costs and the growing number of jurisdictional disputes between the various parties, as is witnessed or the epitome of which is the Grand Gulf plant in Mississippi.

Now, turning specifically to the Ratepayer Protection Act, as I understand the Ratepayer Protection Act it is a relatively simple amendment to the Federal Power Act which would, under certain conditions, explicitly grant State public utility commissions the authority to determine what, if any, portion of wholesale power rates approved by FERC to pass along to retail customers.

I believe enactment of the bill S. 1149 will generate at least six specific desirable results. First, the bill clarifies the jurisdictional boundaries of the various regulatory parties.

Second, the bill will have the practical effect of creating a very strong incentive for associate members of public utility holding companies to submit their construction plans to home State public utility commissions for a prudency review prior to the time that irrevocable and potentially financially disastrous results are incurred.

Third, since the bill is not applicable in situations where State public utility commissions have undertaken a prudency review, the bill would protect shareholders from ex post facto confiscatory rates based on the benefits of 20/20 hindsight.

Fourth, in cases where State public utility commissions were not availed of the opportunity to review the reasonableness of powerplant costs, the threat of some disallowance of these costs will provide a significant incentive for firms to do everything in their power to provide electricity most efficiently through prudent and timely investments. These incentives are likely to generate substantial cost savings over time due to more efficient plant construction programs.

Fifth, the bill reduces the current incentive for electric utilities to organize themselves in potentially inefficient ways to bring more of their activities under the jurisdiction of what they perceive to be a more lenient regulatory body.

Finally, given the commonly perceived bias of utilities toward overcapitalization, the Ratepayer Protection Act very reasonably encourages a regulatory environment wherein State public utility commissions review the prudency of investment decisions *ex ante.*

In conclusion, there is currently an inconsistency in Federal regulation legislation that permits, in the case of a public utility holding company with a wholesale subsidiary, to pass the additions to be made in two jurisdictions with effective control in neither.

This inconsistency undermines the ability of States to regulate capacity additions, since capacity they may be obliged to take is being constructed independent of their control and oversight. This deficiency is addressed in S. 1149.

Also, as I have just described, the bill produces a number of beneficial side effects. As a result, the bill represents, I believe, a very contribution to the legitimate role of Congress in defining the broad parameters within which regulatory bodies and firms might operate more effectively.

Thank you.

[The prepared statement of Dr. Mayo follows:]

TESTIMONY OF DR. JOHN W. MAYO
RESEARCH ASSISTANT PROFESSOR
CENTER FOR BUSINESS AND ECONOMIC RESEARCH AND
ASSISTANT PROFESSOR OF ECONOMICS
THE UNIVERSITY OF TENNESSEE
Before the
U.S. SENATE ENERGY AND NATURAL RESOURCES COMMITTEE
Subcommittee on Water and Power
July 23, 1986

Mr. Chairman and other members of the Committee it is a genuine pleasure to have the opportunity today to speak to you on a matter of significant importance to the development of sound public policy toward the electric utility industry.

Since finishing my Ph.D (Washington University, St. Louis, 1982), I have taught at both the University of Tennessee and the Virginia Polytechnic Institute (VPI). From June of 1984 to June of 1985, I served as an economist for the Senate Small Business Committee. In addition, I have consulted on regulatory matters and testified in regulatory hearings on several occasions. My principal field of specialization is industrial organization, which includes the areas of antitrust economics and the economics of regulated industries. My primary research interest is the application of microeconomic analysis to public policy issues, and I believe that interest is reflected in the various papers I have published on electric utility regulation, the economic effects of petroleum firms' diversification on industry costs and prices, and the evolving regulatory policy in the telecommunications industry.

During the late 1970s and early 1980s, many students of the electric utility industry noted with considerable alarm the financial distress of various electric utilities around the country. Concurrently, there was a push for regulatory and legislative relief to help salvage the fiscal integrity of regulated utilities. For the most part, the industry's financial health is now considerably improved, and with that improvement the apparent urgency of public policy reforms seems to have faded somewhat. Nevertheless, there remain a number of fundamental public policy issues within the electric utility industry that are worthy of public debate.

For instance, should ratepayers or shareholders bear the fundamental responsibility for inordinately expensive powerplants? What prudency standards should apply to utility investments, and when should they be imposed? Should the cost of construction work in progress be permitted into an electric utility's rate base? Should electric utilities be permitted to diversify into nonutility activities, and, if so, under what circumstances? What, if any, portion of the electric utility industry should be deregulated?

It has never been the role of Congress in general, or this Committee in particular, to resolve each and every regulatory issue that comes before the public. Regulatory issues such as those I have mentioned have traditionally been handled by regulatory rather than legislative bodies.

Moreover, these issues have typically, and appropriately, been handled at the state rather than the federal level. It is, however, the role of Congress to establish the broad regulatory parameters within which the states might most effectively accomplish their task of ensuring the efficient and equitable provision of electric power to the citizens within their states. Also, while Congress must ensure that its role is broad, allowing state regulatory agencies the latitude to resolve specific regulatory issues as they see fit, Congress should provide the various regulatory bodies with clear jurisdictional boundaries - both to ensure proper coverage of regulation and to prevent costly interjurisdictional disagreements. If this Congressional role is to be accomplished, policymakers should fully inform themselves of the economic, legal and equity implications of both current and prospective federal statutes that constitute the national foundations of regulatory policy. Accordingly, the purpose of my testimony is, first, to report to you the economic implications of current regulatory policy in the electric utility industry and, second, to describe how this perspective on the economics of electric utility regulation sheds light on the specific merits of S. 1149, the Ratepayer Protection Act.

THE ECONOMICS OF ELECTRIC UTILITY REGULATION

Regulation of the electric utility industry arose in the 1890's from the belief that, when taken as whole, the technology and demand conditions in the industry were such that the provision of electricity within a given market area is subject to natural monopoly supply. As a result of these natural monopoly conditions, a single firm in a given market area can supply electricity most efficiently, however, in the absence of regulatory control, monopolistic pricing would emerge. Ideally, then, rate-of-return regulation permits the most efficient industry structure for the provision of electricity (i.e., a single firm within a given market area) but also prevents the excesses typically associated with monopoly. In that vein, a primary goal of regulation is to achieve an allocation of resources similar to that which would prevail if, in fact, competition were viable.

Against this ideal, rate-of-return regulation as it is currently practiced has been shown by a substantial body of economic research to have a number of shortcomings. For instance, in the 1960s and 1970s a significant amount of research indicated, under a wide variety of plausible industry conditions, that rate-of-return regulated firms have a profit-maximizing incentive to employ production techniques that are, from an efficiency perspective, too capital intensive. Also, the truncated nature of the returns of rate-of-return regulated firms have been shown to retard significantly those firms' incentives to engage in innovative activities. This retardation in turn has led to dynamic efficiency losses.

Finally, recent research has indicated that by allowing regulated firms to pass along costs that are endogenous to their decision-making process, modern-day regulation has tended to attenuate regulated firms' incentives for cost minimization. For example, consider the introduction and spread of the fuel adjustment clause as a regulatory device to facilitate regulated firms' abilities to pass along fuel cost increases to consumers without expensive and protracted regulatory hearings. The practical effect of the fuel adjustment clause was to shift the risk of fuel cost increases from owners of the firm to consumers. Research by several economists subsequent to this shift in the risk-bearing responsibility found that as a result of placing the risk of the fuel cost increases to a greater degree on consumers, firms became somewhat lax in their efforts to minimize the cost of purchased fuel. (See, for example, D.L. Kaserman and R. C. Tepel, Southern Economic Journal, Volume 48, Number 3, January 1982, pp. 687 - 700.)

Some industry observers have called attention to these distortions in regulated firm behavior and have argued that deregulation of the electric utility industry would eliminate these unnecessary costs. The case for outright deregulation of the electric industry is, however, far from clear. While economies of scale at the generation stage now appear to be significantly smaller than originally thought, the presence of economies of vertical integration between electricity generation and distribution still provide for natural monopoly conditions over most ranges of output. Given, then, the continued prevalence of natural monopoly conditions in the provision of electricity, outright deregulation of the industry does not appear to be the solution to the current distortions in regulated firm behavior.

But to decide against adopting a policy of outright deregulation in this industry does not mean that policy makers should ignore the lessons of the competitive marketplace. For instance, a fundamental lesson from the operation of competitive markets is that profits from innovative behavior and losses from incorrect managerial decisions will provide the maximum incentives for efficient behavior. Also, as pointed out by Adam Smith over 200 years ago, competitive markets have the attractive property that firms and consumers, each acting in their own self-interest will, by virtue of the invisible hand, maximize the welfare of both. In this sense, the competitive market aligns the interests of consumers, who seek low prices, with those of producers who, through efficient production and pricing seek to earn profits. In contrast to competitive markets, regulation all too often pits the interests of consumers and shareholders against each other. It is clear that, by reforming regulation to increase the correlation between managerial performance and allowed rates of return, managers will have an increased set of incentives for providing electricity in the most efficient manner possible.

The importance of heightening managerial incentives for cost minimization in the electric utility industry should not be underestimated. To date, sunk costs in cancelled nuclear powerplants, plants that will never produce a single kilowatthour of electricity, have amounted to approximately $18 billion. Over 100 nuclear powerplants that were originally planned have now been cancelled. Moreover, overly expansionary electric utility construction projects have led to reserve margins in the 34-35 percent range, in contrast to the 15-20 percent that most industry analysts suggest is needed to meet the typical vicissitudes of consumer demand and unexpected plant outages. While uncertainty and the possibility of incorrect decisions exist in any industry and cannot be totally eliminated, a significant amount of incorrect decision making may be avoided in the future if regulated firms are given the proper incentives for cost minimization. Simply put, increased industry efficiency cannot reasonably be expected until those responsible for the efficient provision of electricity are held accountable for their actions.

Another necessary step for regulation is the need to coordinate and align, to the extent possible, the interests of the relevant regulatory bodies and regulated firms. This requires that there be a strong element of commonality in the regulatory approaches of the federal regulatory agencies (in this case the Federal Energy Regulatory Commission (FERC)) and the state public utility commissions. Unfortunately, there is a widening disparity in the regulatory approaches at the federal and state jurisdictions. Exemplary of this disparity is the present treatment of nuclear powerplant construction costs. In the case of cancelled plants, federal and state approaches appear to be tolerably similar; both allow a return of prudently invested capital but allow no rate-of-return on that capital. The approaches to the determination of prudently incurred costs and the treatment of excess capacity do, however, differ markedly at the state and federal levels. While state regulators have been diligent in their inquiry into the prudency of plant construction costs, the FERC has only rarely made findings of imprudence. In fact during the past five years, not a single dollar of utility construction costs has been disallowed by the FERC as imprudent (see the March 14, 1986 response of Chairman Sousa to prehearing questions submitted by Representative Edward Markey, Chairman, Subcommittee on Energy Conservation and Power). Also, given the de facto prudency of investments made in the FERC jurisdiction, the FERC has never disallowed any of the costs associated with excess plant capacity. As I have already noted, this propensity to absolve regulated firms from accountability tends to attenuate incentives for cost minimization. Moreover, it tends to create an environment in which firms may engage in strategic regulation shopping.

Yet another aspect of this disparity is the territorial intrusions recently made by the FERC into regulatory issues that have traditionally been handled at the state level. Consistent with the fundamental federal legislation in the area of electric utility regulation (the Federal Power Act of 1935 and the Public Utility Holding Company Act of 1935), retail electric utility regulation has fallen primarily into the province of state public utility commissions. Yet, in the case of the Grand Gulf Nuclear Power Plant, the FERC, aided by a narrow interpretation of the so called Narragansett doctrine, preempted the authority of the Arkansas, Louisiana, and New Orleans public utility commissions from determining the appropriate level of retail electricity rates by imposing a mandatory cost allocation of power from a plant that had never been subject to a review of the prudency of the investment. According to testimony presented before the House of Representatives' Subcommittee on Energy Conservation & Power earlier this year, the FERC is currently attempting to prevent several more state regulatory commissions from engaging in prudency reviews. At a minimum, these recent interjurisdictional struggles should be put to an end by some clarification of the roles and responsibilities of the various regulatory bodies. In the absence of such action, costly gaps and redundancies in the regulation of electric utilities will continue to emerge with increasing frequency.

Given this rather broad perspective on electric utility regulation, the question arises as to what specific contribution S. 1149, the Ratepayer Protection Act, makes to improve the regulatory parameters within which the various regulatory bodies might operate to most effectively ensure the efficient provision of electricity. It is to that issue that I now turn.

THE ROLE OF THE RATEPAYER PROTECTION ACT IN NATIONAL REGULATORY POLICY

As I understand the Ratepayer Protection Act, it is a relatively straightforward amendment to the Federal Power Act which would, under certain conditions, explicitly grant state public utility commissions the authority to determine what, if any, portion of federally approved wholesale power rates to pass along to retail customers.

As with many pieces of federal legislation, it appears that the origins of The Ratepayer Protection Act are rooted in a specific problem, which is symptomatic of a larger problem with national regulatory policy. In the case at hand, the FERC, through its rulings on the Grand Gulf Nuclear Powerplant, has effectively made impotent state public utility commissions' fundamental authority in the area of regulating retail electricity rates. Although the decision to build the Grand Gulf plant was never subjected to the approval of the affected local regulatory bodies, the FERC has allocated three and one-half billion dollars of powerplant costs to local operating companies. In so doing, the FERC forced the affected utilities to take expensive capacity regardless of the need for that power. The rather complicated legal and historical details of the Grand Gulf case are best addressed by other witnesses. Nevertheless, it seems clear that the merits of the bill as it applies specifically to the Grand Gulf case are sufficiently strong to warrant support for the bill. Beyond any specific remedy offered for the inequities of the Grand Gulf situation, however, the generic aspects of the bill are likely to prove to be the bill's most redeeming features.

Enactment of the Ratepayer Protection Act will generate at least six desirable results. First, the act clarifies the jurisdictional boundaries of the various regulatory bodies. Entirely too much time and costly resources are currently spent by regulated firms and regulators debating the boundaries of federal and state regulatory jurisdiction as a result of unclear legislation. This bill makes a significant contribution by more clearly delineating the boundary between federal and state authority. Moreover, the bill is clearly consistent with the cornerstone piece of public utility regulation--the Federal Power Act of 1935, which established federal regulation in the power industry to fill the void created by the isolated absence of state regulation. This bill provides a clear beacon to state public utility commissions that it is their fundamental and frontline responsibility to ensure efficient provision of electric power at reasonable rates.

Second, the bill will have the practical effect of creating a strong incentive for associate members of public utility holding companies to submit their construction plans (even for plants beyond the state's boundaries) to home state public utility commissions for a prudency review prior to the time that irrevocable and potentially disastrous financial decisions are incurred. This will add to the initial regulatory costs (which are likely to be minuscule compared to the $3-4 billion investment decisions being made), but is likely to save billions of dollars by halting wasted investments through the judicious use of the ex ante review process.

Third, since the bill is not applicable in situations where a state public utility commission has undertaken a prudency review, the bill would also protect shareholders from ex post confiscatory rates based on the benefit of 20-20 hindsight. Specifically, where a state's public utility commission has approved the construction of a power plant, federally approved power rates must be flowed through as reasonable to retail customers.

Fourth, in cases where state public utility commissions were not availed of the opportunity to review the reasonableness of a plant, ex ante, the bill grants state commissions the authority to determine what portion, if any, of the federally approved costs to pass along to retail customers. While commissions are still bound by their mandates to avoid confiscatory rates, the threat of some disallowance of costs will provide a significant incentive for firms to do everything in their power to provide electricity most efficiently through prudent and timely investments. Such incentives are likely to generate substantial cost savings due to more efficient plant construction in the future.

I might note here that some industry observers have expressed the belief that by placing more cost responsibility on electric utilities the regulated firms' cost of capital will be driven up, thereby defeating efforts to ensure the low cost provision of electricity. While these concerns about the impact of regulation on firms' cost of capital, are legitimate, they should not be overdramatized in the case at hand. For two reasons I tend to believe that the market cost of capital may very well decline under S.1149. First, by encouraging an *ex ante* review process the range of uncertainties associated with the provision of electricity are narrowed. These declines in industry-wide risk should lead to commensurate reductions in the cost of capital. Second, while assigning risk to shareholders, *ceteris paribus*, leads to increases in the cost of capital, this same assignment of risk bearing will lead to efficiency gains that have the effect of reducing the overall cost of capital.

Fifth, the bill partially eliminates the current incentive for electric utilities to reorganize themselves in potentially inefficient ways that bring more of their activities under the jurisdiction of what they perceive to be a more lenient regulatory body. While many arguments have been made about the potential for cost savings from power pooling (which most formally is represented by the public utility holding company), economic research indicates that the *realized* cost savings from public utility holding companies are either minimal or nonexistent (see, e.g., L. R. Christensen and W. H. Greene *Land Economics*, Volume 54, Number 2, May 1978, pp. 139-155). This is because any cost advantages from the holding company form of organization tend to be offset by the increased coordination and contracting costs of associate members of holding companies. Moreover, there is no indication that holding companies are likely to be more dynamically efficient than stand-alone companies. In fact, one of my current research efforts indicates that, ceteris paribus, participation in a holding company reduces individual firms' R & D efforts by $1-1.5 million annually. (See J. W. Mayo and J. Flynn, mimeo, Department of Economics, The University of Tennessee, Knoxville, 1986). If the holding company form of organization is to exist in the electric utility industry, it should be because it is an efficient form of organization, not because of an artificial incentive due to imprecise boundary definitions between federal and state authorities.

Finally, given the commonly perceived bias of utilities toward over-capitalization, it is reasonable to encourage an environment wherein state public utility commissions review the prudency of investment decisions ex ante. (See the long-standing literature on over-capitalization beginning with the H. A. Averch and L. J. Johnson American Economic Review, Volume 52, December 1962, pp. 1052 - 1069). This literature is summarized in R. Sherman (Review of Industrial Organization, Fall 1985). By encouraging utilities to seek ex ante approval of construction plans, the Ratepayer Protection Act will act to discourage the overcapitalization bias inherent in rate-of-return regulation.

In conclusion, it seems that there is currently an inconsistency in federal legislation that permits, in the case of a public utility holding company with a wholesale subsidiary, capacity additions to be made in two jurisdictions with effective control in neither. This inconsistency undermines the ability of states to regulate capacity additions since capacity they may be obliged to take is being constructed independent from their oversight and control. This current deficiency in national regulatory policy is addressed in S. 1149. Moreover, as I have noted, enactment of the bill would provide a number of salutary side effects. As a result, the bill represents an important contribution to the legitimate role of Congress in defining the broad regulatory parameters within which regulatory bodies might operate more effectively.

Senator **Bumpers**. Thank you, John.
Professor Schuler.

STATEMENT OF DR. RICHARD E. SCHULER, PROFESSOR OF ECONOMICS AND CIVIL AND ENVIRONMENTAL ENGINEERING, CORNELL UNIVERSITY

Dr. **Schuler**. Senator, it is a great pleasure to have the opportunity to come before you this afternoon to discuss my observations of the evolution of the electric utility industry with which I have been involved, one way or another, for over 25 years and, I might add, on all sides of the fence. Initially I was an electrical engineer in the 1960's with a power company; subsequently, an academic economist; and more recently I served as public service commissioner in New York State. So I have seen these debates and heard the arguments from a variety of perspectives.

What I have also seen is that the industry has just changed dramatically in those 25 years. You have alluded to a number of those changes: the unpredictability of demand forecasts. What has changed is load growths are much lower over the past decade than they were in the past.

The rapid escalation in the cost of constructing new powerplants is also something new over the past decade, and that escalation is far in excess of the overall economywide rate of inflation.

Finally, bottoming out of decreasing costs of generating power of the size of those facilities increases may be a more profound change that has taken place. After all, it was that decreasing cost nature that is used to argue the natural monopoly regulating status in the first place, and it is that change that has brought to bear some of the recent calls for partial deregulation of the generation of electricity.

At the same time, at least the regulatory hearing process has changed. Twenty years ago, I do not think we would have had a hearing like this before a Senate committee, at least with some of the recriminations I sense today. Certainly at the State level there are more hearings, they are longer, and they are certainly more rankerous. There is an intervention by an increasing number of parties representing a kaleidescope of special interests.

Furthermore, even when the regulatory body reaches a decision, those decisions are then litigated on and on. I would like to paraphrase a comment that a FERC commissioner, Charles Stalon, made a couple of years ago in a dissent, when he said that litigation only ends when all of the conceivable economic benefits are captured by the lawyers, the consultants and their witnesses.

Well, I would like to discuss a framework for the future regulation of this industry that might accommodate some of these underlying technical changes which would save some of those benefits, both for the customers of utilities and for their investors.

The emphasis I am going to place is on trying to design, and I am going to give a generic discussion into which I think S. 1149 fills two important parts, a generic discussion of flexible regulation that acknowledges the fact that different regions in the country have different needs and cost patterns. That has, really, two major points once accomplished, two things: first of all, to encourage the parties, that is, the utilities and the State regulators, whether they be in their own State or across States, to enter into voluntary agreements wherever possible about these power plants and the transactions, contracts if you will; and second of all, enter into those agreements sooner rather than later in the planning and construction process.

I think one of the problems of regulation in the past is that it has been a perfect hindsight business, and then there is a lot of blame to throw around. If people are asked and forced to commit and encouraged to commit ahead of time, I think that is terribly important.

I think it is important to think about this in the context of interstate holding companies, because they are by far the most difficult to regulate. If any scheme works with them, then it is certainly going to work on interstate transactions between companies that are not holding companies, and it will certainly work on intrastate transactions.

So there are really two kinds of decision that I would like to talk about: the decision on whether the capacity is to be built; or whether commitments are to be made to transact that new capacity if it is an interstate kind of transaction. Those are precisely the kinds of decisions I think that you have contemplated in S. 1149.

To that, I would also like to add consideration of decisions on how to price that power or at least the pricing mechanism that is to be used, because if you are making those decisions ahead of time you may want to build in escalators tied to a consumer price index, or at least the rate treatment, but at least some decision on pricing.

Then, of course, the State regulators can either make a decision on that or they may not make a decision. I consider inaction as effectively not making a decision or disagreeing.

So it is essentially a framework that contemplates four possible combinations, two decisions, and either you approve or you do not approve. The principle that applies is if people do not agree, then that clearly on interstate transactions is a Federal matter, and FERC is the one that ought to resolve those issues.

On the other hand, if on either of those issues the parties agree, then presumbly FERC should stay out, unless they can show that those decisions coopt or preempt the ability of other contracts to be performed satisfactorily.

Now, let us see how that works in a specific context, and I jotted down the notes, let us think about the KYARK holding company, Kentucky and Arkansas. Suppose someone is building a powerplant in Kentucky, and Arkansas thinks they might like to have the power. As I understand it under your bill, if Arkansas agrees to take that capacity, and your bill says nothing about decisions up front on how to pay for it precisely, then presumably, since there is no decision on pricing, yes, that agreement on taking the capacity is like a firm contract. The pricing decision is left to FERC.

I think what your bill adds is explicitly what happens if the parties do not agree on either of those issues. Now, as a general principle, you could say that FERC would therefore decide on both, except I agree with you wholeheartedly, Senator Bumpers, that under no circumstances should FERC be able to force Arkansas customers to accept any of that power.

That is kind of a new notion of a market to me. It is the case where the producer of a product has a right to go out on the street, get a customer by the throat, put a gun to his head, and say you will buy and, therefore, if the person buys, that is legal.

I must also add that there needs to be a symmetry to that position as well. If neither of the parties have agreed, then presumably there is no way the State of Arkansas should be able to force the State of Kentucky to sell them that power at anything other than a FERC-approved rate. So there is a case where there is no agreement.

Now, what I am proposing to suggest as an addition is, let us take the circumstances where there is also an up-front agreement on the pricing mechanism. Well, if they agree on both the price and the quantity of power, it seems to me what you have is a long-term contract there. Certainly, it seems to me that that ought to stand, and FERC ought to keep out of it.

There is also the possibility where Arkansas thinks that they may need some coal-fired power from Kentucky, that they may agree on the pricing and say I am not sure I want any of the capacity. Again, presumably that decision between the parties entered into voluntarily would resolve the issue about pricing.

Now, what does this accomplish? Well, first of all, what I have described is a simple framework that would allow deregulation of generation to come about very naturally, because it sets up a framework for insuring the sanctity of contracts, and all FERC was concerned with in those cases was do those contracts in some way threaten the ability to perform on other contracts.

Are there any incentives for these parties to enter into these agreements? I think certainly in any State that sees a prospective growth in demand, they have a tremendous incentive to contract for a quantity of power to be sure they get it, and it would certainly be nice to do that at a predictable price.

What about the utilities? Well, I think as you have alluded to in many of your questions, I would think a utility would be happy to have an up-front approval. It would be far more difficult for the State to come back later on and say, hey, that was an imprudent decision if they had already approved it.

Second, I think the investors would be happy to have a pricing agreement up front, because at least they would have some assurance of what the revenue flow is.

Let me say that what I think might be the overall greatest benefit of some scheme is that effectively what it begins to do is apply pressure on the utililities and regulators to reverse the order of regulation. What we have had historically is cost-plus regulation. The costs are revealed, and then from that we determine our price. That is not the way the market operates. The competitive market, with its pressures for efficiency, has a price determined in the marketplace and then producers try to beat that. They try to produce at a lower cost.

To the extent that price contracts or mechanisms are put in place ahead of time, it seems to me it puts an added incentive on the utility's back to try to complete those plants just as expeditiously, efficiently and with as low as costs as possible.

Thank you.

[The prepared statement of Dr. Schuler follows:]

7/23/86

U.S. Senate Committee on Energy and Natural Resources:
Subcommittee on Water and Power

Statement of Dr. Richard E. Schuler
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on

S.1149, A Bill Proposing Amendments to
the Federal Power Act

Mr. Chairman and members of the Committee, it is a pleasure to have the opportunity to share my views with you of changes that may be desirable in the future regulation of electric utilities. At the same time, the immediate topic, the efficient regulation of prices and energy flows between utilities in different states, in particular when those utilities are affiliates of the same holding company, is fiendishly complex and subject to a vast array of perverse incentives and opportunities for all parties involved to push costs off on others.

In the more than twenty-five years that I have been involved with the electric utility industry and with energy issues -- initially as an electrical engineer and manager with a power company during the 1960s, subsequently as an academic economist at Cornell since 1972 writing widely on these issues, and more recently as a public service commissioner in New York State -- I have observed an industry whose technological characteristics, cost patterns, and customers' demands and opinions have undergone massive changes. That is why I am convinced that existing patterns of regulation must also be adjusted to keep up with the fundamental technological and economic realities; regulation should be designed to serve the needs of an industry's customers and investors and to spur its managers into producing as efficiently as possible, not the reverse.

Furthermore, I have previously testified before the Senate on the matter of interstate utility holding companies while serving as a Commissioner and Deputy Chairman of the New York State Public Service Commission. Those 1982 and 1983 statements were directed at proposals to modify the Public Utility Holding Company Act of 1935, and they described the fundamental need to exercise some Federal control over interstate holding companies. At the same time, I also advocated delegating the maximum possible authority to individual states, recognizing that needs, costs, and preferences vary widely among various regions of the country.

I. THE SETTING: CURRENT REGULATION/INDUSTRY CHANGES

The issues under discussion today do not dispute the need for Federal oversight of interstate electric holding companies; the focus is upon who should make decisions and when should they be made about the terms of transactions between utilities in two different states. Obviously, without the Federal Energy Regulation Commission's (FERC) ability to monitor the terms of transactions, in previous eras when electricity generation was in short supply, an interstate holding company operating in one state would have been able to sign a contract with its affiliate in another state for the much needed electricity at an arbitrarily high price. If no alternative supplies were available in the buying state, its public service commission would have had little choice but to pass on those high prices to its customers since its authority could not reach across state lines. But, one reason that the Federal role in monitoring the terms of interstate transactions has come under discussion is because times have changed. Many states enjoy near-term (and some, long-run) excess supplies of utility capacity. And in the case of many new nuclear units, but also increasingly for coal-fired capacity, the costs of new facilities have escalated at rates far in excess of the economy-wide rate of inflation. Furthermore, not only has the historic high rate of growth in electricity demand moderated in the United States, but also the historic pattern of decreasing unit costs with ever increasing sizes of generating units bottomed out more than a decade ago. That is why, even if utilities do not contemplate the construction of any additional nuclear plants, the problems addressed in this statement will not go away.

So it is in light of this rapid recent change of electricity demand and cost patterns, plus the heightened uncertainty about future trends, that I will discuss modifications in the means of monitoring the terms of interstate power transactions. And because of the substantial uncertainties, I urge you to do what all smart investors do: hedge your bets and build as much flexibility into the system as possible.

Two distinct trends have emerged in electric utility regulation as a result of these rapidly changing factors. Many utilities complain that state regulatory bodies are increasingly sticking the entire risk of those uncertainties on the utilities' investors by reaching decisions only with the benefit of perfect hindsight. Conversely, many consumer advocates argue that on the utilities is precisely where the risk belongs if they are to formulate facility plans that are in the public interest. In the midst of this debate, proposals continue to emerge to deregulate in part the generation of electricity since this portion of the business may no longer be a natural monopoly, given the extent of demand in many regions of the country. (In fact, the Public Utility Regulatory Policy Act of 1978 may be interpreted as a first small step in that direction.)

II. A FRAMEWORK FOR ANALYZING NEEDED CHANGES

The intent of my recommendations is to recognize these changing patterns and to reduce the contentiousness of regulatory proceedings by encouraging utilities and state regulatory bodies to enter into as many voluntary agreements as possible -- contracts if you will -- regarding the terms of transactions for generation supplies. Furthermore, incentives are described to reach those agreements sooner, rather than later in the utility planning and construction process. Certainly this would have to be the nature of all bulk power transactions, both intra- and interstate, if electricity generation were ever to be deregulated, but even in the existing, highly regulated environment, voluntary reductions in the costs of drawn-out administrative hearings and protracted litigation could be extremely beneficial to society. Nevertheless, the club-in-the-closet of potential FERC intervention must be retained, both to prevent the re-occurrence of the historic public harm that interstate utility holding companies have the potential to inflict under particular circumstances, and to insure that individual states and utilities in different states honor the terms of transaction agreements for bulk power that they might enter into.

Within this framework, I will describe four alternative scenarios that might arise between state regulators and utilities supplying generation that are located in different states. In each case, the necessary role of FERC is also outlined, but the primary thrust of these proposals is to encourage voluntary agreements between the states and utilities in other states, if desirable, and to encourage those agreements to be made sooner rather than later. While, as an economist, I have no special expertise in suggesting legislative language and I have no intention of doing so, by laying out the following four alternative scenarios I hope to illustrate the type of changes that might be beneficial. Furthermore, I am delighted that the proposals in S.1149 either explicitly or implicitly would accomplish my objectives under two of the four scenarios; S.1149 had not contemplated the other two situations that I have added for your consideration.

The regulatory guidelines I propose are straight-forward and simple, in principle, and they operate over two alternative, but related types of state approvals and/or agreements with utilities affecting the construction and transfer of power from a utility in another state. The two types of approvals and/or agreements are concerned with:

A. The construction of generating plants and/or firm commitments to transfer power.

B. The price of or methodology for computing the price of power to be transferred, including capital costs to be included in the buying state's utility's rate base.

For both issues I propose that state regulators be given the opportunity to make two choices: they may act and/or reach an agreement with the utility, or they may choose not to act or not to agree with the utility. These two choices over each of the two issues listed above lead to the four possible scenarios described in detail below.

S.1149 recommends altered FERC regulatory responses depending upon a state's choice on the first issue, the need for capacity. I would like to emphasize my view that the second, pricing/rate base issue is also important and that the desired extent and jurisdiction of regulatory oversight should hinge on the combination of state responses to both of these issues.

III. CHOICES AND DESIRED FERC RESPONSE UNDER EACH SCENARIO

A. Construction of Capacity Commitments

While strictly speaking, a state regulatory commission in Maine has no authority to approve or disapprove of a power plant to be constructed in New York, it can approve its own utilities' plans to participate in the construction of that plant or to make firm arrangements to acquire power from that plant when it is completed. That is the type of approval I have in mind under the first decision, and the state regulatory body has two choices when the plant is planned:

1) It can approve the arrangement (and thereby, implicitly, the need for the plant),

2) It can disapprove of the arrangement, or it can refuse to reach any decision.

There are really two alternatives under 2), but they should lead to the same result: there should be no guarantee that the state's utility will receive any allocation of power from the plant when it is completed, either if the state initially refused to act or if the state regulators initially said the power was not needed and then changed their minds when the plant was completed. Under either of these circumstances, the constructing utility has some advance warning of the public uncertainty regarding the need for the additional capacity. Of course if the utility believes the states are wrong and builds the plant anyway, and the new capacity is needed desperately upon the plant's completion, then the constructing utility is in the driver's seat; although, subsequent transfer arrangements can obviously be entered into at any time when both parties agree to terms.

A.1 The State Approves Capacity (B.2 Implied — No Agreement on Price)

What does a state's regulatory body acquire for its citizens if it sticks its neck out and approves the need for the power supply? The answer is: what any customer receives if they sign a long-term contract, a guarantee that the agreed-upon quantity of power will be allocated solely for their use upon the plant's completion. So if demand is growing rapidly, it may behoove the state's regulators to approve the new power supplies early on; however, if demand growth slackens, the state regulators will indicate their uncertainty about additional construction plans either by not acting or explicitly disapproving proposed interstate arrangements. (Notice that it may be desirable for state regulatory bodies to adopt the same procedures on intrastate bulk power supply arrangements, and in effect many states do, but that is not a Federal issue.) Should a state not act because of a propensity to avoid making tough decisions, that inaction will have obvious consequences if electricity demand continues to grow, either in terms of supply shortages or a last minute scramble to secure other sources of supply, undoubtedly at higher prices.

This is the type of state approval, I believe, that is contemplated in S.1149, and under its provisions, if the state has given prior approval of the capacity, it would accept FERC's subsequent determination of a proper price and rate base allocation. What is not stated explicitly is that in exchange for that approval, the state should also receive a guaranteed allocation of the specified quantity of generation when it is completed, with FERC standing ready to enforce the terms of that approval. What I would also add is that in those circumstances where a utility is unwilling to make firm arrangements for bulk power supplies, and its state's regulators order it to make necessary arrangements and/or invoke a penalty for not doing so, that action initiated by the state regulators should also be deemed a prior approval by that state.

A.2 State Inaction on Capacity Need (B.2 Implied — No Price Agreement)

What is new in S.1149 is a spelling out of consequences when the utility makes a commitment, but state regulators have not acted[1] or have explicitly disapproved the need for those new supplies. Under those circumstances, I agree entirely with the provisions of S.1149 that the state should not be required to take any of the power, and it certainly should not be required to pay for any energy from or have any of the capital costs associated with that plant included in the rate base of its own in-state utility. Here I would add a caveat, however: neither should that out-of-state utility be required to deliver any power, subsequently, to that state at any price or under any conditions less than what FERC has specified. I emphasize the word, required. Should the generating entity have no alternative outlets for its power, it may be desirable to permit the generating company to enter into a voluntary agreement at some later date to transfer that power at less than the FERC-approved price. Alternatively, should the demand for power begin to escalate rapidly, the other state's regulators might be willing to pay more than the FERC-approved terms. This introduces the second option of voluntary agreements between state regulators and an out-of-state generating company regarding the price of transactions or the methodology to be used in computing that price and the capital costs to be included in rate base. While this option is not explicitly provided for in S.1149, it is a natural extension.

B. State Approvals/Agreements on Pricing Terms/Methodologies

The price options and their regulation should be simple for interstate transactions. If regulators in one state and a utility constructing a generating facility in another state agree on the methodology for computing the price of transactions and/or rate base treatment (Case B.1), FERC should have no involvement with the pricing terms other than to insure that they are enforced should either party attempt subsequently to renege. On the other hand, if the state regulators and out-of-state utility fail to reach agreement on price/rate base amounts or computational methodology, the FERC would step in and assert its customary rate-making role as an arbiter (Case B.2). This yields the four possible scenarios, two of which have already been discussed in terms of whether or not the state makes a commitment for additional capacity, where it was implicitly presumed that FERC would determine the price terms which under my proposals presumes that the state regulators and utility have not agreed upon pricing terms. What I propose to add is that FERC should only be responsible for establishing those prices when the states and utilities in other states cannot reach a voluntary agreement about the dollar terms of exchange or its computational method. Naturally, FERC should review all agreements to be sure they do not threaten the performance of other previously agreed-upon arrangements (contracts) with other states or other prior FERC arbitrated arrangements. Otherwise, voluntary agreements should pre-empt FERC's involvement, except to enforce the terms of those agreements.

B.1 Parties Agree on Price & A.1 State Approves Capacity

Consider the two possible cases where the regulatory commission in one state has reached an agreement with a utility in another state about rate base treatment of allocated capacity and the price for delivered power. If this agreement were coupled with an approval of the allocation of a specified amount of generating capacity at the time the plant was initially planned, the agreement would have the flavor of a long-term contract.[2] In this case there would be no intrusion by FERC; there is no need to, unless this arrangement violates prior agreements with other states, or one of the parties subsequently attempts to renege on its agreement. The contracting state receives the agreed-upon capacity, priced in accordance with the parties agreed-upon method. Similarly, the utility can initiate construction, certain of a buyer for its power and of the terms of the transaction. Of course such voluntary agreements could be reached at any time during the planning, construction, or operating life of the facility so long as spare capacity were available and the new agreement did not abrogate previous agreements with other states. All of these agreements would be approved without FERC's customary rate-making intrusion.

B.1 Parties Agree on Price & A.2 No State Action on Capacity

It is also conceivable that one state's regulators and a generating utility in another could reach agreement on the pricing methodology for bulk power transfers, but that the state regulators would not act on approving the plant or a specified amount of capacity. Under such a partially-hedged arrangement, the state is not making a commitment to buy any power, so the generating company has no obligation to sell, but they are agreeing that if at some future date a firm contract for power delivery is reached, they already have agreed upon the pricing terms/methodology and do not have to be subjected to the uncertain outcome of a subsequent FERC rate-setting determination.

Of course, should either or both parties feel they could do better under a normal FERC rate-making review, they would simply refuse to agree on the pricing terms, and FERC would initiate its customary pricing review when the power transactions begin. Under this circumstance, the process would revert to the two options contemplated under S.1149: either the state has (Case A.1, B.2) or has not (Case A.2, B.2) approved the quantity of out-of-state generating capacity that is to be made available.

Note, even if the utility and the other state's regulators do not agree on any terms, and if the state does not approve the need for additional capacity so FERC establishes the price for purchases, if any (Case A.2, B.2), the same two parties should be allowed to enter into subsequent well-defined arrangements for the transfer of specific amounts of electricity at prices other than the FERC-approved rates, if both parties agree, provided that this new arrangement does not threaten the ability of the utility to fulfill any other prior agreements with other states.

IV. INCENTIVES FOR UTILITIES AND THEIR STATE REGULATORS

What would be accomplished, I believe, by these proposed procedures would be to introduce a greater degree of certainty into the utility planning/pricing process since it would encourage both parties to agree about the nature and terms of interstate power transfers, in many cases without the administrative costs of a full-blown FERC review. Certainly it would be in the interest of a utility's potential investors to know that a prior arrangement had been reached on the quantity and terms of future power delivery, in many cases before the plant was begun. The usual utility lament that the composition of state regulatory commission's members changes rapidly over time so that states cannot be relied upon to uphold their agreements (the argument that a previous commission's decision may not be binding on a subsequent commission) is less likely to be aired if FERC is empowered to enforce the terms of previous agreements for interstate transfers. Furthermore, if circumstances change after the initial agreements were reached to construct, the state regulators might have a difficult time substantiating a claim that the utility's continued construction of the plant was imprudent, unless the state's regulators reach a further decision that the capacity is no longer needed, in which case they would only be obligated to pay for their share of construction costs up until the point that they ordered the withdrawal. This provides some added protection for the utility's investors against imprudence proceedings based on perfect hindsight; but conversely, it puts the utility on notice, should it continue construction, that doing so is solely at its own investors' risk.

Is there any incentive for state regulators to make these explicit determinations? There is if rapid demand growth is contemplated; if it is not, there is some question whether or not the new capacity should be built, and in that case it would be proper for the utility's investors to bear the risk of uncertain future demand. In that case the cost of financing probably would rise, and the price of power from the completed plant, if needed desperately later on, should also rise to reward investors for taking that risk.

But at the same time, these procedures would continue to insulate utility customers in one state from attempts by an associated utility in another jurisdiction from passing on inordinate costs of generation plant construction, if the potential consuming state never claimed to want any of that power. To be sure, consumers in a consuming state could be harmed by power shortages, and they would be subject to FERC's continued imposition of pricing terms and rate base treatment for interstate capacity that was available, if that state's own utility regulators consistently declined to approve either capacity needs or pricing procedures. But that would be a within-state problem, and a powerful incentive exists for each state to get its own house in order.

Nevertheless, each state would be protected from exploitation by utilities in another state, all parties would have an incentive to reveal their best projections about the future demand for and cost of electricity supplies, all parties would have incentives to reach voluntary agreements about the quantity and terms of future transactions where consensus existed, and all parties would be free to change their minds, knowing full well what the costs, if any, would be of abrogating a previous agreement. This simple four-way set of alternatives for reaching decisions could easily accommodate moves toward the deregulation of bulk power supplies. But in the current heavily regulated environment it could also provide powerful incentives to keep construction costs down if prior agreements on pricing procedures are reached. Under that circumstance the normal cost-plus pricing process for setting utility service rates will have been just reversed, with the price or pricing mechanism set in place before the costs are incurred. It is precisely that reversed, price-comes-first sequence that provides the cost-cutting innovative spurs in a competitive market economy. Thus the real benefit that might be derived from implementing these proposals is in providing added motivation for utilities to hold their costs down. In that happy event, both the utilities' investors and their customers would be the beneficiaries.

FOOTNOTES

1. Here a slight modification in the amendment's language may be required to encompass the case in some states where a separate power plant siting board or a state energy office, not the state commission, grants these approvals.

2. Given the history of rapid inflation in construction costs of new power plants over the past decade, it is likely that these "pricing" agreements would focus on the methodology for determining rate treatment, including adjustment clauses tied to overall construction cost indices. The inclusion of incentive/penalty provisions might also be desirable, but that should be left to the parties.

Senator **Bumpers**. Thank you, Dr. Schuler.
Professor Sherman.

STATEMENT OF DR. ROGER SHERMAN, PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA

Dr. **Sherman**. Senator, I appreciate this opportunity to express my views on S. 1149 and the regulatory relationship between the FERC and State regulatory commissions. I can summarize my written testimony briefly.

Over most of the many debates in the last 100 years that led to existing institutions for regulation, sound investment by public utilities was largely assumed. The debates over how to value assets to determine profit allowances for regulated firms received far more attention than a fundamentally more important question, which is whether to allow any return at all on some assets.

This question has arisen more recently in rate cases, and it is difficult to answer because there is no entry and exit in these regulated industries, and there is no competitive market test for investment success.

State regulatory commissions have imposed a requirement that assets be used or useful in order to receive a return; that the investment decisions pass a prudency test; and in some cases that assets be completed and productive rather than in a stage of construction.

When powerplant construction projects have been canceled, some State commissions have not allowed any amortization of their costs. Some State commissions also have reduced in some way the rate base eligible to receive a return when they conclude that the utility is building excessive or unneeded capacity.

In these latter decisions especially, State commissions have attempted to produce results somewhat like a competitive market, where excess capacity in relation to demand, whatever the reason it was built, will not earn a normal return.

One of the hardest questions for a regulatory commission to answer is whether to allow a normal return on assets of a public utility when they are not needed to meet its maximum expected demand or are far more costly than sound management would allow. The competitive market is ruthless in cases like this, and shareholders usually suffer.

If a return is allowed on excessive assets in a regulated industry, it will cause prices to be higher and shift risks of a decline in demand or accountability for management failure over to consumers instead of placing them on shareholders. That is why the decision to disallow return on excessive capital is crucially important to maintaining incentives for sound management in the long run.

Many State commissions have struggled to deal with this important question, whether assets are genuinely needed and should receive a return. FERC essentially has not pursued this question, perhaps because FERC's responsibility has been limited to wholesale electricity transactions that traditionally have accounted for a relatively small portion of one electric utility sales.

An evaluation of investment soundness requires attention to an entire organizational unit and the demand it is responsible for supplying, a scope of responsibility that can be defined well only at the retail level.

Given the present separation of regulatory responsibilities between State and Federal levels of government, one attractive means of affording evaluation of investment soundness is to grant State commissions more authority to do it. This is possible, and S. 1149 proposes a way to do it without altering seriously the present distinction between State and Federal responsibility.

Each State commission might be invited to evaluate the capital portion of any rate paid by a company it regulates for wholesale electricity to be distributed to that company's retail customer. This means that if a company the State commission regulated were to purchase electricity from another company at a FERC-approved wholesale rate, that rate could be examined by the State commission to be sure it included no return to capital judged to be excessive.

It is possible for the FERC-approved rate to be paid by the regulated company, if and when it purchases wholesale electricity, but part of that rate would not be permitted in the charge to the company's retail customer. This would preserve the FERC's right to establish a wholesale rate it would impose on the buyer and the State commission that regulates it a responsibility for the soundness of the purchase.

A great variety of arrangements could be consistent with FERC approval of wholesale rates but not require that any purchases actually be made at those rates. The rates would hold only if purchases were voluntarily made. Indeed, requiring that certain purchases must be made at prescribed rates is an unnecessarily rigid practice, and it can prevent competition in some instances where it might be effective.

Thank you.

[The prepared statement of Dr. Sherman follows:]

STATEMENT OF ROGER SHERMAN
PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA
BEFORE THE
WATER AND POWER SUBCOMMITTEE OF THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
July 23, 1986

Chairman Murkowski and Members of the Subcommittee:

I appreciate this opportunity to express my views on S. 1149 and the regulatory relationship between the FERC and state regulatory commissions.

The dividing line between state and federal regulatory responsibilities has been drawn crudely between retailing of electricity (state regulation) and wholesaling of electricity (federal regulation). But whether transactions are at the retail or wholesale level can be determined to a degree by public utility decisions about organizational form. So, in effect, public utilities can now decide whether they want to be regulated by state or federal government. Efforts by state regulatory commissions to evaluate the soundness of utility investments will be discouraged where public utility choice of organizational form can deny their authority to examine the issue. Consumers can suffer as a result because they may be required to pay for generating capacity that should not have been built. Shareholder incentives to oversee management will be weakened as a consequence, too, so public utility organizations may not evaluate alternative investments as careful or conserve capacity as effectively as they otherwise would.

The institutions of public utility regulation were developed in the past century. Drawing guidance from previous court decisions, state regulatory commissions now establish a rate base for a public utility, which is an accepted valuation of the utility's assets, and then allow a rate of return on that rate base to establish a profit level for the utility. The allowed profit level is then combined with costs to determine a set of prices which can be charged by the utility so revenues will cover costs and yield the allowed level of profit. The rate base and rate of return determinations are extremely important matters because the assets are so enormous; an electric utility's assets can easily be worth two or three times as much as the utility's annual sales. This means, for example, that allowing a 10% return to the assets of an electric utility can require that 20% or 30% of the value of sales be devoted to that purpose.

Whether to use original cost or replacement cost to value assets and calculate allowed profit is an old, and major, issue for the institutions of public utility regulation in the U.S. These institutions grew largely from court decisions establishing the power of states to regulate certain private enterprises in the last quarter of the 19th century and the first quarter of the 20th. The main questions at issue then were: What is a public utility?, and What profit should a public utility earn? Because the price level was falling in the late 1800's and rising in the early 1900's, it was very difficult for parties to agree on original assets value or replacement cost as a generally applicable basis for calculating profit allowance. For more than half a century in the development of utility regulation, this asset base and profit allowance question dominated as the perennial issue, and the practices and procedures of regulation were aimed primarily at answering it.

The debate over how to value assets to determine profit allowances received far more attention than a fundamentally more important question, which is whether to allow any return at all on some assets. This question has arisen more recently in rate cases and is difficult to answer because, in the absence of free entry and exit, it is difficult to create a regulatory equivalent of the competitive market test for investment success. State regulatory commissions have imposed a requirement that assets be "used and useful" in order to receive a return, that the investment decisions pass a prudency test, and in some cases that assets be completed and productive rather than in a stage of construction. When power plant construction projects have been cancelled, some state commissions have not allowed any amortization of their costs. And some state commissions also have reduced in some way the rate base eligible to receive a return, when they conclude that the utility has built excessive, or unneeded capacity. In these latter decisions especially, state commissions have attempted to produce results somewhat like a competitive market, where excessive capacity in relation to demand -- whatever the reason it was built -- will not earn a normal return. Shareholders, who oversee management, suffer rather than consumers when excess capacity arises in competitive markets.

Will a public utility build only needed capacity? Incentives within the regulated firm received virtually no attention when rate-of-retrn regulation was being developed. An institution that results from settlement of courtroom disputes cannot be expected to possess ideal features,and that is certainly true of public utility regulation. Many perverse incentives of the existing regulatory institution have been uncovered, incentives which invite excessive capacity, monopolistic rate structures rather than efficient peak and off-peak rates, other than cost-minimizing behavior, and biases in choice of financing arrangement.* In recent years state commissions have devoted more attention to the effects of their decisions and policies on efficiency incentives within regulated public utilities, but many unwanted effects remain very difficult to avoid.

One of the hardest questions for a regulatory commission to answer is whether to allow a normal return on assets of a public utility when they are not needed to meet its maximum expected demand or are far more costly than sound management would allow. A competitive market can ruthlessly punish firms and their shareholders in such a situation. If a return is allowed on the excessive assets in a regulated industry, it will cause prices to be higher and thereby shift risk of a decline in demand or accountability for management failure over to consumers instead of placing them on shareholders. That is why the decision to disallow return on excessive capital is crucially important to maintaining incentives for sound management in the long run.

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* For analyses of these issues see H. Averch and L. Johnson, "Behavior of the Firm under Regulatory Constraint," American Economic Review, Dec. 1962, E. E. Bailey and L. J. White, "Reversals in Peak and Offpeak Prices," Bell Journal of Economics, Spring 1974, C. Eckel, "Customer Class Pricing by Electric Utilities," University of Virginia Ph.D. Dissertation, 1983, R. Sherman and M. Visscher, "Rate-of-Return Regulation and Two-Part Tariffs," Quarterly Journal of Economics, Feb. 1982, and R. Sherman, "Financial Aspects of the Regulated Firm," Southern Economic Journal, Oct. 1977.

Many state commissions have struggled to deal with the important question whether assets are genuinely needed and should receive a return. The FERC essentially has not pursued this question, perhaps because FERC responsibility has been limited to wholesale electricity transactions that traditionally have accounted for a relatively small portion of one electric utility's sales. An evaluation of investment soundness requires attention to an entire organizational unit and the demand it is responsible for supplying, a scope of responsibility that can be defined well only at the retail level of sales.

Given the present separation of regulatory responsibilities between state and federal levels of government, one attractive means of affording evaluation of investment soundness is to grant state commissions more authority to do it. This is possible as S. 1149 proposes without altering seriously the present distinction between state and federal responsibilities. For instance, each state commission might be invited to evaluate the capital portion of any rate paid by a company it regulates for wholesale electricity to be distributed to that company's retail customer. This means that if a company the state commission regulated was to purchase from another company electricity at a FERC approved wholesale rate, that rate could be examined by the state commission to be sure it included no return to capital judged to be excessive. It is possible for the FERC approved rate to be paid by the regulated company if and when it purchases wholesale electricity, but part of that rate not be permitted in the charge to the company's retail customers. This would preserve the FERC's right to establish a wholesale rate, but would impose on the buyer (and the state commission that regulates it) a responsibility for soundness of the purchase.

Power would thus be sold at FERC approved rates, but a company's decision to purchase might be questioned for prudence by the state regulatory commission. And if the purchase is found later to have been imprudent the company could be denied the right to pass through the full FERC approved rate. A FERC approved rate might be reasonable in general but still imprudent for a company in particular circumstances to purchase at, as for example when the company itself has excessive capacity. A stronger grant of power to state commissions would permit them not only to deny the pass through to consumers of the purchased power rate, but also would change the wholesale rate at which the purchase between companies took place. But this would question more sharply the current division of responsibilities between state and federal government.

A great variety of arrangements could be consistent with FERC approval of wholesale rates but not require that any purchases actually be made at those rates. The rates would hold only if purchases were voluntarily made. Indeed, requiring that certain purchases must be made at prescribed rates is an unnecessarily rigid practice that could prevent competition in some instances where it might be effective.

S.1149 provides that a regulatory commission would relinquish its opportunity to evaluate the price of purchased power from a company, once the commission had given approval of that company's construction of generating capacity and had approved some contracting arrangement adopted by the companies involved. This provision weakens the overall proposal by preventing the commission from disallowing capacity charges in the event of a later decline in demand. But it still offers a review of investment soundness, which currently may be omitted from consideration.

I shall not discuss so called production cost equalization arrangements, which essentially pool the capacities and costs of members of holding-company types of organizations, except to note that they obviously reduce efficiency incentives by forcing associated companies with low capacity costs to share the high costs of less efficient companies. Let me also note that any organizing arrangement cannot be evaluated according only to its effect on the cost of capital. An arrangement that shifts risks and other burdens to consumers is very likely to have lower capital costs, but that does not mean it is desirable since it will almost certainly reduce efficiency incentives.

Thank you.

Senator **Bumpers**. Dr. Sherman, you have heard the testimony this afternoon from various witnesses about the rush to FERC. Under all these different arrangements right now a consortium, power-pooling arrangement, or a holding company who can do essentially what was done here, it seems to me that it is terribly uneconomic for the ratepayers because the utilities do not have to justify the costs or the need for the power. They simply engage in an arrangement under which they get a certificate. Now, they did have to get a certificate in the instant case.

Then they sell the certificate or transfer the certificate to a subsidiary like MSE and at that point they are really pretty much free to do as they please. They can build the plant. Louisiana, Arkansas, New Orleans have had no input into the decision. They build whatever capacity they want at whatever costs they choose, and FERC does not inquire into that. They simply say you spent $3.5 billion, and here is a way to get it back. They divided it up among all the subsidiaries. The holding company can't lose.

Now, that is a disincentive to economize. Do you agree with that?

Dr. **Sherman**. Absolutely; it also is a disincentive on the shareholders. They do not have to watch as closely the wisdom of these——

Senator **Bumpers**. As we say in Arkansas, they have a bird-nest on the ground.

Dr. **Sherman**. At best, it takes away from their incentive to watch these managements.

Senator **Bumpers**. Dr. Schuler, some of your comments were interesting to me. As we envision the operation of this bill, it is that the utility will come to the State. Now, in this case, NOPSI would have had to go to the New Orleans Public Service Commission. Arkansas Power & Light would have had to go to the Arkansas Public Service Commission. LP&L to Louisiana, et cetera.

Now, there is every reason to believe that, if they needed the power and they could present to them proof that they could build that power at a reasonable cost and for less than they could buy it from somebody else, those public service commissions would give them the authority to do that.

Let us assume that two companies said "Yes," and one said "No." Assume the particular utility that said "No" went ahead and joined with the other two and proceeded to do it. At that point, FERC just looks at the costs and says "here is a way to allocate the rates," and so on. Now, if my bill were law, the two companies who got permission would go back and have to prove that the representations they made had largely come true.

Now let me say, to go back a little bit, when they asked the public service commission for permission, under my bill, if it is a utility holding company, to engage in this consortium to build the capacity, the public service commission would say, "OK," you say this is going to cost $1 billion and you are going to generate so many megawatts of power, and that when you get through you are going to have 20- to 30-percent reserve capacity, and we feel that that is adequate, and this is all justified.

Those are the ground rules that the public service commission could set up, and if the utilities comply they should have nothing to fear. That public service commission should be bound by the arrangement they made with the utility on the front end.

Now, if the utility come back with a whole different arrangement, and the cost overruns are staggering, and the thing is not going to generate as much power as they thought it would, then the public service commission that gave them the authority to build should have the opportunity to say, look, we are going to stick with our end of the bargain, and your shareholders are going to have to eat the rest because this is all we agreed to. Is that fair?

Dr. **SCHULER**. I have heard nothing unfair. I think what you are describing is a contract, and that is essentially what I would like to see encouraged.

Now, there are a couple of ingredients. You start out with a scenario of three States, two of them approving. Let us take that as a scenario.

Senator **BUMPERS**. I was going to take the ones who got approval first, but go ahead.

Dr. **SCHULER**. Let us take that. It seems to me, then, the holding company is on notice that it only has a firm market for two-thirds of the power of the plant. If it decides to go ahead with a larger plant, fine; but it is like a builder building on speculation. It seems to me the other third of that capacity ought to be dealt with in that framework, or perhaps the utility might scale back the size of its plant. That is the way I would contemplate this process proceeding in the case of two States approving, one not approving.

Now, let me put on the other hat. Let me put on the hat of the utility. The utilities would say you cannot trust State commissioners. Commissions change all the time.

Senator **BUMPERS**. I think that is the conventional wisdom among them, do you not agree?

Dr. **SCHULER**. Commissioners change, and one commission cannot bind another. Well, that may be literally true, but on the other hand it seems to me that is one of the roles that FERC could play in this scenario. Once that deal had been cut, then FERC ought to be available to see that one State does not begin to play a pernicious game with another State and try to palm off costs on each other, particularly on interstate transactions, so that an agreement is upheld as an agreement.

Now, the third issue you raised, I think, in connection with that was the question of the terms, and that was what I was trying to make a little bit more explicit in my suggestions and the testimony.

Let us suppose that not only did they put in a term but they say we will tell you what it is going to cost in today's dollars. Everyone knows these plants take a long time to build. We cannot be sure about what inflation is going to do in the future, so we will tell you a cost in today's dollar, and we will track it with inflation. It could conceive of an arrangement like that.

It seems to me, again, that is like a contract. If later on the State regulatory body were to pull out and say, "No, we do not like those terms any more," it is like breaching a contract, and they therefore ought to be subject to some penalties or at least payment of the costs incurred up to the time that they pulled out.

Senator **Bumpers**. One Congress cannot bind a succeeding Congress, and the same thing is true of public service commissions. If that public service commission had changed, however, and they tried to renege on the deal, the courts ought to enforce that just like it would be enforced the other way around. That is what we are trying to establish here.

Now, there is one other point, and that is if the utility company that was denied permission to enter into this agreement comes back later and say, "Well, you did not give us permission but we still felt we needed the power, so we have entered into this agreement, and we have contracted for a certain amount of this power," and so, that public service commission can say, "Get out of here, we told you not to do this," or they can say, "OK, put on your evidence and we will decide what is reasonable under the circumstances."

It is just a risk that the utility takes. It is not as though the commission will pass nothing along. For example, right now Middle South is saying, "If you undo the Grand Gulf I thing, that constitutes a taking and a denial of due process." My argument to that is it does not constitute a taking until the Arkansas Public Service Commission says, We are not going to give you a dime."

Until that happens, until there is a confiscatory rate, there is nothing unconstitutional. That is the point at which the constitutional issue, in my opinion, has to be raised. I have wandered all over the lot here.

Dr. **Schuler**. It seems to me, under the existing framework, we frequently have a game of what I would like to call regulatory chicken, where everyone kind of waits until the last minute, particularly if you have a holding company involved. It is always nice as a regulator to wait until the last minute, because then you have the benefit of perfect hindsight. In many of these situations, I do not think that is fair.

In the longrun, it is in nobody's interest, but at the same time in the same circumstance, if you have a holding company building that plant, it may also find it in its interest to wait, to not seek those approvals because a more favorable circumstance or jurisdiction may evolve in the future.

I think we have seen too much of that in the past to try to turn that around, which motivated me to offer the suggestions that I did to you this afternoon.

Senator **Bumpers**. John, I have one question for you, and then I will let all of you go.

You mentioned the efficiencies or lack of efficiencies associated with utility holding companies. What have your studies shown on that?

Dr. **Mayo**. Well, there has been some economic evidence on the issue of economies and public utility holding companies. The evidence is in contrast to the sort of conventional wisdom espoused by those people who argue that public utility holding companies will result in tremendous cost savings.

There is some economic evidence to suggest that that realized cost savings as opposed to the potential that was discussed has either been minimal or nonexistent. While there may be some coordination economies at the generation stage and from trading powers, it also increases contracting costs and costs involved in the enforcement of those contracts, as we have seen in the case of Middle South utilities.

It has turned into a nightmare. I suspect, if anything, those contracting costs have tremendously increased the cost of public utility holding companies.

Senators **Bumpers**. OK, Dr. Mayo, Dr. Sherman and Dr. Schuler, thank you all for coming. I appreciate your testimony very much.

Our last panel this afternoon is Joseph Dowd, senior vice president and General Counsel, American Electric Power Company; John Barr, managing director, Morgan Stanley; Mr. Fred Greeman, senior vice president and General Counsel, New England Electric System; George White, vice president, Middle South; and Peter Bradford, chairman of the Maine Public Utilities Commission.

Mr. Dowd, your name is first on the witness list. We will take them as I read them off. If you would please proceed, and thank you for coming.

STATEMENT OF A. JOSEPH DOWD, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN ELECTRIC POWER SERVICE CORP.

Mr. **Dowd**. Thank you, Mr. Chairman. We appreciate the opportunity of being here today to talk about a bill that is of great concern to the American Electric Power system.

American Electric Power, AEP, is a holding company system. It is registered under the Holding Company Act of 1935. It supplies energy to the public through eight operating subsidiaries located in seven east central States.

AEP is a highly-integrated electric utility system whose high voltage transmission grid spans the seven States of its service area. It is centrally planned, centrally designed, built and operated to achieve the economies and efficiencies that are inherent in the large-scale generation and transmission of electric energy.

For example, AEP has about 2,000 miles of 765 kv transmission lines. Now, this is the highest voltage in operation in the United States. Also, its size has enabled it to place in operation five 1,300 megawatt coal-burning generating units, also the largest in operation in the United States, with a sixth nearing completion.

The resulting economies and efficiencies inure to the benefit of all its customers and are reflected in the fact that the electric rates of the AEP system companies are either the lowest or are among the lowest in the States in which they operate.

In 1985, for example, AEP's average cost of energy to all retail customers was 5.09 cents per kilowatt hour, compared to a national average of 6.7 cents per kilowatt hour. That is 25 percent under the national average. However, the efficiencies which AEP has achieved during the past several decades could never have been realized if S. 1149 had been applicable law during that period.

Now, Mr. Chairman, we have heard a lot of concern about the ratepayer this afternoon. We heard Mr. Dozier talk about the Kentucky Power situation, one of our subsidiaries, in his State. We did not hear Mr. Dozier tell you what Kentucky Power's average retail rate was. It is 4.68 cents per kilowatt hour. It is 30 percent lower than the national average.

Now, is the blight that the American Electric Power system has visited on the ratepayers of Kentucky? Why are the rates so low? The rates are low because this is an integrated electric utility system that has been able, over the years, to avail itself of the economies of large-scale generation and high voltage transmission. We can build plants bigger and avail ourselves of the economies of scale because we have a large system. If these seven companies were stand-alone companies, they could not support capacity of this size.

Now, Mr. Chairman, we also heard Mr. Dozier mention Kentucky Power in some other ways. The fact of the matter is, Kentucky Power is a member of the American Electric Power system pool. Kentucky Power has not contributed capacity to that pool since 1968. It is the most capacity deficient company on the American Electric Power system. This is a very difficult problem.

The Public Service Commission of Kentucky has actively prevented Kentucky Power Company from adding capacity over the past 5 years. Now, what this really comes down to is simply that the cost of the newer capacity, the higher cost capacity, is being shifted to our consumers in other States. Looked at properly, I am not sure that is a State versus Federal kind of an issue. It is a question of equity.

What we are saying is that where a number of States are involved, there has got to be an impartial and a strong Federal umpire to make the call. It is improper, in our view, when you are dividing up a pie to permit each State to decide the size of its own share. There has got to be a strong Federal agency, for better or for worse, to make an impartial decision, and there has got to be a Federal judiciary that will make that decision stick.

I thank you very much, sir.

[The prepared statement of Mr. Dowd follows:]

PREPARED STATEMENT OF A. JOSEPH DOWD

Mr. Chairman and members of the Subcommittee, my name is Joseph Dowd. I am Senior Vice President and General Counsel of American Electric Power Service Corporation. American Electric Power is a holding company system registered under the Public Utility Holding Company Act of 1935. It supplies electric energy through eight operating subsidiaries to approximately 2,600,000 customers located in seven east central states. It is a highly integrated electric utility system whose extra high voltage transmission grid spans the seven states of its service area. AEP is centrally planned, designed, built and operated to achieve the economies and efficiencies that are inherent in the large scale generation and transmission of electric energy. For example, it has about 2,000 miles of 765-kv transmission lines -- this is the highest voltage in operation in the United States. Also, its size has enabled it to place in operation five 1300-megawatt coal-burning generating units -- also the largest in operation in the U.S. -- with a sixth under construction. The resulting economies and efficiencies inure to the benefit of all its customers, and are reflected in the fact that the electric rates of AEP System companies are either the lowest or are among the lowest in the states in which they operate. In 1985, for example, AEP's average cost of energy to all retail customers was 5.09 cents per kwh, compared to a national average of 6.70 cents per kwh. However, the efficiencies which have been achieved by the multi-state AEP System during the past several decades could never have been realized if S. 1149 had been applicable law during that period.

I appreciate the opportunity to appear before you today in opposition to S. 1149. This bill would deprive the Federal Energy Regulatory Commission (FERC) of jurisdiction over certain interstate wholesale power transactions among associate companies of a public utility holding company system. Specifically, it would allow a state regulatory commission to refuse to recognize, for retail ratemaking purposes, a rate or charge fixed or permitted to take effect by the FERC which is applicable to transactions among associate companies operating in different states and which is based in whole or in part upon an allocation of electric energy or the costs of production of electric energy from a generating unit which was built to serve customers in a number of states. In such instances, the bill would conflict with the June 17, 1986 decision of the United States Supreme Court in the Nantahala Power & Light Co. case which emphatically reaffirms the filed-rate doctrine and the Narragansett line of cases that mandate retail pass-through of FERC-accepted rates.

In AEP's opinion, this bill could erase more than a half century's progress in the interstate interconnection and coordination of electric facilities, which the federal government, under the Federal Power Act, is charged to "promote and encourage"[1]. It would seriously jeopardize the economies that have been made possible by such interstate coordination, and therefore would raise customers' electric rates, instead of lowering them.

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[1] 16 USC 824a(a).

It is universally accepted that interconnection and coordination of the facilities of separate electric companies is in the public interest. Among the most obvious benefits of such coordination are: (1) the exploitation of economies of scale in building generating and transmission facilities; (2) the avoidance of unnecessary duplication of facilities; (3) the ability to place generating facilities at the most advantageous sites, regardless of ownership; (4) increased reliability because of the availability of emergency support from interconnected systems; and (5) operating economies which can be achieved by dispatching the lowest cost generation, regardless of ownership, to serve demands on the interconnected and coordinated systems.

Because of these and other considerations, numerous coordination and power pooling arrangements have been entered into over the years between and among electric utilities. These range from simple agreements to exchange emergency and economy energy to complex power pooling arrangements which allow several companies in different states to operate as a single integrated electric system. In this latter category are the holding company systems, such as AEP. The holding companies, through their interstate power pooling arrangements, have achieved a high degree of efficiency and economy in their multi-state operations. The Public Utility Holding Company Act, 15 USC §79a et seq, mandated the breakup of the giant utility holding companies that had developed up to that time; but recognizing the value of integrated power systems, the Act allowed electric utility holding companies to continue to exist insofar as they operate as integrated systems in geographically contiguous areas. Id., §§79b(29); 79k.

The AEP System has been among the most successful in developing and expanding the advantages of interstate interconnection and coordination for the benefit of all its customers. Though the System's generation and transmission facilities are owned by the major operating companies, the facilities are centrally planned, built and operated as a single electric system. Membership in the AEP System allows the member companies to build much larger and more efficient power plants than would be possible for the members as stand-alone utilities. These plants are tied together by an extensive network of extra high voltage (EHV) transmission lines, which enable power to be transferred instantaneously anywhere throughout the AEP System. This EHV transmission network allows power plants to be sited where it is most economically advantageous, and also allows the power needed by any AEP company to be generated from the most economical sources on the System at any given time, irrespective of location or ownership. The EHV transmission network also makes possible strong interconnections with neighboring utilities. The AEP System has more than one hundred such interconnections with twenty-five neighboring utilities. This, in turn, assures reliability in case of emergencies and also makes it possible for the AEP companies to sell power to other utilities when the available supply is temporarily in excess of AEP's needs, thereby defraying costs which otherwise would be borne by AEP System customers.

The bottom line is that the centrally planned and operated nature of the AEP System has allowed it to supply electric energy to its customers reliably and at a low cost.

The legal framework for the centralized planning and operation of the AEP System is provided by the System Interconnection Agreement, or "Pool Agreement", which was originally filed with the FPC (now the FERC) more than thirty years ago, and more recently by the AEP System Transmission Agreement, filed with the FERC in 1984. The Interconnection Agreement, besides providing for the integrated planning and operation of the System, also provides mechanisms for the equitable sharing of costs of generating capacity among the AEP pool members. The Transmission Agreement provides for the equitable sharing of the costs of the EHV transmission system.

Coordination and power pooling agreements such as the AEP Interconnection and Transmission Agreements are subject to the jurisdiction of the FERC under Section 201 of the Federal Power Act (FPA)[2] because they involve the sale of electricity at wholesale and transmission of electricity in interstate commerce. Further, Section 202(a) of the FPA[3] imposes upon the federal government the duty to "promote and encourage" the voluntary interconnection and coordination of electric facilities. In

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[2] 16 USC §824.

[3] Id., §824a(a). The FPC's functions under this section were transferred to the Secretary of Energy by the Department of Energy Organization Act, 42 U.S.C. §§7101 et seq.

1978, as part of the Public Utility Regulatory Policies Act, Congress further emphasized the primacy of federal jurisdiction over interstate power pooling. That Act specifically empowered the FERC to exempt electric utilities from any state law, rule or regulation that would prohibit or prevent interstate pooling arrangements[4].

Federal regulation of interstate power pooling agreements is not only a legal reality, it is a practical necessity. Any successful power pooling arrangement requires the participants, to some extent, to subordinate their individual interests to the interests of the pool as a whole. A pooling arrangement simply will not work if each participant continually seeks to maximize its own benefits or minimize its own costs at the expense of the other participants. Yet this type of behavior is likely to be encouraged by the state commissions that regulate the retail rates of the individual pool members. There is strong, politically-appealing sentiment that the local companies should not be concerned with what is fair to all members of the pool, but should act as advocates on behalf of the customers in their own states. Further, when two or more states are affected by a power pooling agreement, the probability is that they will have differing opinions concerning the overall fairness of that agreement. There is an obvious need for an impartial body, such as the FERC, to umpire these disputes among state jurisdictions, and to arrive at power pooling arrangements that are fair to all participants and not unduly discriminatory or preferential with respect to any participant.

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[4] Id., §824a-1.

The scheme of regulation presently provided for in Part II of the FPA fills this need. Power pooling agreements, since they are contracts for or affecting the transmission or sale at wholesale of electricity in interstate commerce, must be filed with the FERC as rate schedules pursuant to Section 205 of the FPA[5]. The FERC, under Section 205 or Section 206[6], must find that the agreements are just and reasonable and not unduly discriminatory or preferential. Under Section 308 of the FPA[7], any interested state commission is allowed intervention in any FERC proceeding. In their role as intervenors in the FERC proceedings, the state commissions can, and do, act as advocates for the customers within their respective jurisdictions. Of course, this well-designed regulatory scheme will not work if the state commissions are not bound to accept and abide by the FERC's final determination of the matter, but are in effect free to accept it or reject it in whole or in part, as contemplated by S. 1149.

Not only is state regulation of sales of electricity at wholesale in interstate commerce impractical, it was found by the

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[5] Id., §824d.

[6] Id., §824e.

[7] Id., §825g.

United States Supreme Court to be unconstitutional in the Attleboro case[8]. Part II of the Federal Power Act, 16 U.S.C. 824 et seq., was enacted as "a direct result of Attleboro", which "left no power in the states to regulate . . . sales for resale in interstate commerce, while the [FPA] established federal jurisdiction over such sales". F.P.C. v. Southern Cal. Edison Co. ("Colton")[9]. Section 201(a) of the FPA declares that

> [T]he business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest, and that Federal regulation of matters relating to . . . that part of such business which consists of the transmission of electric energy in interstate commerce and the sale of such energy at wholesale in interstate commerce is necessary in the public interest, such Federal regulation, however, to extend only to those matters which are not subject to regulation by the States.[10]

In Colton, the Court held that the FPC (FERC) has plenary jurisdiction over "all wholesale sales of electricity in interstate commerce" and that the language in Section 201(a) of the FPA that "such Federal regulation to extend only to those matters which are not subject to regulation by the States" is only a policy declaration and "cannot nullify the clear and specific grant of jurisdiction" to the FERC under Section 201(b). The Court continued:

> [O]ur decisions have squarely rejected the view . . . that the scope of FPC jurisdiction over interstate

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[8] Pub. Util. Comm'n of Rhode Island v. Attleboro Steam & Elec. Co., 273 U.S. 83 (1927).

[9] 376 U.S. 205, 214-15, quoting from United States v. Pub. Util. Comm'n of Cal., 345 U.S. 295, 308 (1953).

[10] 16 USC §824(a).

> sales of gas or electricity at wholesale is to be determined by a case-by-case analysis of the impact of state regulation upon the national interest. *Rather, Congress meant to draw a bright line easily ascertained, between state and federal jurisdiction, making unnecessary such case-by-case analysis. This was done in the Power Act by making FPC jurisdiction plenary and extending it to all wholesale sales in interstate commerce except those which Congress had made explicitly subject to regulation by the States. There is no such exception covering the Edison-Colton sale.*[11]

This language was repeated almost verbatim in *New England Power Co. v. New Hampshire*[12], in which the Supreme Court again held that the Federal Power Act delegated to the FPC [FERC] *exclusive* authority to regulate the transmission and sale at wholesale of electric energy in interstate commerce, and struck down, as "protectionist legislation that the Commerce Clause declares off-limits to the states", an order of the New Hampshire Commission prohibiting New England Power from selling outside the State of New Hampshire its cheap hydroelectric power generated within the state. Thus, S. 1149 is in direct conflict with the policy underlying the Federal Power Act as envisioned when the FPA was enacted in 1935 and as since interpreted by the United States Supreme Court.

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[11] *Id.*, at 215-216, *emphasis added*; *see also* *Ill. Nat. Gas Co. v. Central Ill. Pub. Serv. Co.*, 314 U.S. 498, 506-7 (1942); *Conn. Light & Power Co. v. F.P.C.*, 324 U.S. 515, 527 (1945); *Panhandle Eastern Pipe Line Co. v. Pub. Serv. Comm'n of Ind.*, 332 U.S. 507 (1947); *Pa. Water & Power Co. v. F.P.C.*, 343 U.S. 414 (1952).

[12] 455 U.S. 331, 339-41 (1982).

Thus, the Supreme Court has made it absolutely clear that the Federal Power Act and Natural Gas Act were intended by Congress to ensure that a state could not interfere with the regulation of interstate wholesale sales of electricity or gas either directly or indirectly. In discussing the jurisdiction of FERC under the Natural Gas Act, substantially identical in its terms and purpose to the Federal Power Act as to jurisdiction,[13] the Court stated:

> The federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas, . . . or for state regulations which would indirectly achieve the same result . . . . These state orders necessarily deal with matters which directly affect the ability of the Federal Power Commission to regulate comprehensively and effectively the transportation and sale of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act. They therefore invalidly invade the federal agency's exclusive domain. . . . This relationship [federal versus state regulation] is a matter with respect to which Congress has given the Federal Power Commission paramount and exclusive authority. . . . Not the federal but the state regulation must be subordinated, when Congress has so plainly occupied the regulatory field[14].

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[13] See F.P.C. v. Sierra Pacific Power Co., 350 U.S. 348, 353 (1956), and Arkansas Louisiana Gas Co. v. Hall, 453 U.S. 571 (1981). In the latter case the Court held: "The rates that a . . . company files with the [FERC] for sale and transportation of gas are lawful only if they are 'just and reasonable.' No court may substitute its own judgment on reasonableness for the judgment of the [FERC]. The authority to decide whether the rates are reasonable . . . is vested solely in the [FERC]. . . . Except when the [FERC] permits a waiver, no regulated seller of natural gas may collect a rate other than the one filed with the [FERC]. . . ."

[14] Northern Nat. Gas Co. v. State Corp. Comm'n of Kansas, 372 U.S. 84, 91-92, 93 (1963). (Emphasis added). See also Maryland v. Louisiana, 451 U.S. 725, 747, 751-52 (1981), in which the

(Footnote Continued)

Since state commissions are not permitted to make an independent determination of the justness and reasonableness of FERC-accepted rates, it follows that they must allow costs incurred under those rates as reasonable operating expenses in setting retail rates. This latter principle is known as the "Narragansett doctrine" after the case of Narragansett Electric Co. v. Burke[15]. In that case, the New England Power Company obtained FERC approval for a rate increase for power sold to Narragansett, an affiliated company. The increase included, inter alia, the effects of the amortization of an abandoned generating plant. Narragansett then attempted to pass the increase through in its retail rates. The Rhode Island Commission held that it could disallow a portion of the purchased power costs. The Rhode Island Supreme Court held that under the principle of federal preemption, the FERC's approval of a wholesale rate is tantamount to a declaration that the purchased power cost is a reasonable cost, and that therefore the state commission could not disallow it as an operating expense.

The Narragansett doctrine is a logical extension of the "filed-rate" doctrine announced by the Supreme Court in Montana-

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(Footnote Continued)
Supreme Court declared invalid under the Supremacy Clause a Louisiana first-use tax on the production of natural gas on the basis that it trespassed on the authority of the FERC under the Natural Gas Act to regulate the pricing of natural gas that flows in interstate commerce.

[15] 381 A.2d 1358 (R.I. 1977), cert. denied, 435 U.S. 972 (1978).

Dakota Utilities Co. v. Northwestern Pub. Serv. Co.[16]. *Narragansett* is consistent with several prior cases requiring retail pass-through of rates established by the FPC under the Natural Gas Act[17], has been followed in numerous court cases[18], and just this past June was strongly reaffirmed by the United States Supreme Court in *Nantahala Power & Light Co. v. Thornburg*[19]. The Court said that *Narragansett* and similar decisions ". . . are properly driven by the need to enforce the exclusive jurisdiction vested in FERC over the regulation of interstate wholesale utility rates".[20]

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[16] 341 U.S. 246 (1951).

[17] *E.g.*, *Peoples Natural Gas Co. v. Pa. Pub. Util. Comm'n*, 14 A.2d 133 (Pa. 1940); *Citizens Gas Users Ass'n v. Pub. Util. Comm'n of Ohio*, 138 N.E.2d 383 (Oh. 1956); *United Gas Corp.* v. *Mississippi Pub. Serv. Comm'n*, 127 So.2d 404 (Miss. 1961); *City of Chicago v. Illinois Commerce Comm'n*, 150 N.E.2d 776 (1958).

[18] *E.g.*, *Washington Gas Light Co. v. District of Columbia Pub. Serv. Comm'n*, 452 A.2d 375 (D.C. 1982); *District of Columbia Peoples Counsel v. District of Columbia Pub. Serv. Comm'n*, 444 A.2d 975 (D.C. 1982); *Public Service Co. of Colorado v. Colorado Pub. Util. Comm'n*, 644 P.2d 933 (Colo. 1982); *Northern States Power Co. v. Hagen*, 314 N.W.2d 32 (N.D. 1981); *Northern States Power Co. v. Minnesota Pub. Util. Comm'n*, 344 N.W.2d 374 (Minn. 1984), cert. denied, 467 U.S. 1256, 104 S.Ct. 3546, 82 L.Ed. 2d 850 (1984); *Utah v. FERC*, 691 F.2d 444 (10th Cir. 1982); *Office of Public Counsellor v. Ind. & Mich. Elec. Co.*, 416 N.E.2d 161, 165 (Ind. App. 1981); *Eastern Edison Co.* v. *Mass. Dept. of Pub. Util.*, 446 N.E.2d 684,688 (Mass. 1983); *Appalachian Power Company*, *infra*, n. 21; *Arkansas Power & Light Co.* v. *Missouri Pub. Serv. Comm'n*, U.S.D.C., W.D. Mo., No. 86-4067-CV-C-5, Memorandum and Order, Mar. 10, 1986; *Washington Gas Light* v. *District of Columbia Pub. Serv. Comm'n*, D.C. Ct. of Appeals, No. 85-764, Opinion, May 9, 1986.

[19] 54 U.S.L.W. 4676 (June 17, 1986).

[20] *Id.*, at 4680.

In recent years, the Narragansett doctrine has been under increasing attack. First, a "prudence" exception to the doctrine was articulated by a Pennsylvania appellate court in the Pike County case[21] and by the FERC in several administrative decisions.[22] The Pike County or so-called "prudence" exception states that while a state commission cannot disallow the cost of power purchased at a FERC rate on the ground that the rate is unreasonable, it can disallow the cost on the ground that the utility was imprudent in choosing to purchase the power in light of the availability of more economic sources. Several state commissions immediately seized upon this prudence rationale to begin ignoring FERC determinations with which they disagreed. Even the Supreme Court's definitive decision in Nantahala may not stop this trend,[23] since state commissions can be expected to attempt to distinguish their actions from the facts in Nantahala.

There is, of course, a great deal of political pressure on state regulatory commissions to hold down rate increases -- particularly the relatively large increases that attend the addition of large, new power supply facilities. Since FERC-regulated power pooling agreements often provide for the allocation of costs of new and existing facilities among pool members in various states, the Pike County rationale has led the state commissions to use their purported jurisdiction over "prudence" issues to ignore, for retail ratemaking purposes, the allocation of costs effected by FERC jurisdictional agreements. However, the question of allocation of costs of facilities among several states is uniquely suited for FERC determination. Consequently, the erosion of federal jurisdiction in this area, whether by court decision or by legislation such as S. 1149, would result in chaos in the electric utility industry.

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[21] Pike County Light and Power Company v. Pennsylvania Pub. Util. Comm'n, 465 A.2d 735 (Pa. Commonwealth 1983); see also Commonwealth Elec. Co. v. Dep't of Pub. Utilities, Supreme Judicial Ct. of Mass., No. S-3913, Opinion, April 22, 1986.

[22] E.g., Philadelphia Electric Co., 15 FERC ¶61,264 (1981); Southern Company Services, Inc., 26 FERC ¶61,360; Pacific Power & Light Co., 27 FERC ¶61,080 (1984).

[23] See 54 U.S.L.W. at 4681.

The Subcommittee is no doubt familiar with the dispute that led to the Supreme Court's decision in Nantahala and the tangle of litigation involving the Middle South System and the allocation of the costs of its Grand Gulf nuclear plant among its members pursuant to the FERC's orders 234 and 234-A. I will not, therefore, elaborate on the problems encountered by these other electric systems. The AEP System has been experiencing its own problems in this regard. Certain of the state commissions in AEP's seven-state operating area have been attempting to use the so-called prudence exception to attack the allocation of costs among members of the AEP System under the AEP Interconnection Agreement and Transmission Agreement. A review of these challenges clearly illustrates why it is essential to preserve exclusive federal jurisdiction over such arrangements.

A prime example of how fragmented state regulation would endanger the existence of interstate pooling agreements can be found in the current litigation regarding AEP's Transmission Agreement. As explained earlier, AEP's EHV transmission system benefits all of the member companies by allowing the AEP System to be operated as a single system. In the past, each of the AEP pool members has owned and borne the cost of the EHV transmission lines and associated facilities located in its service territory. This geographical approach to cost responsibility in the past achieved a rough degree of equity of cost sharing among the companies, as each company in turn added facilities in its territory. However, the large increases in costs of EHV transmission lines placed into service recently has caused certain of the members to bear a disproportionately high share of the EHV transmission cost. Since all members benefit from these facilities, it was necessary to arrive at a more equitable method of sharing the costs of the EHV system than had obtained under the geographical system. In 1984 the members entered into a Transmission Agreement which reallocates the costs of the EHV transmission system on the basis of relative demand (called Member Load Ratio, or MLR) instead of the geographical approach followed in the past. Under the Agreement, members whose investment in EHV facilities is deficit in relation to their MLR share must make payments to the members whose investment is surplus. In order to cushion the effect on the deficit or paying companies, the Agreement is phased-in over a five-year period.

The Agreement was accepted for filing by the FERC and allowed to go into effect on January 22, 1985[24]. State commissions and customer representatives from the affected states have intervened in this proceeding and have taken varying positions regarding the justness and reasonableness of the Agreement. Those in the states served by deficit members, who will be making payments, generally oppose the Agreement or have recommended alternatives that result in the deficit companies paying less. Those in the states served by surplus members support the concept but have argued that it should be implemented immediately, rather than phased-in over a five-year period as proposed by the AEP Companies. The matter has been fully heard before a FERC Administrative Law Judge, and an Initial Decision is pending.

In addition to challenging the Agreement before the FERC, certain of the affected state commissions have, based, again, upon the so-called "prudence exception" to the Narragansett doctrine, attempted to disregard the effects of the Agreement for the purpose of setting retail electric rates. The West Virginia Public Service Commission disallowed in the retail rates of Appalachian Power Company, the AEP member in its jurisdiction, $1.6 million in payments to be made pursuant to the Transmission Agreement because the Agreement had not been submitted to the West Virginia Commission for its approval pursuant to a state statute which requires PSC approval of transactions among affiliates. Appalachian Power and the other AEP pool members obtained a preliminary injunction against the West Virginia Commission's order in federal district court, which was affirmed on appeal.[25] On remand, the federal district court permanently enjoined the West Virginia Commission's order on the ground that it violated the Supremacy Clause and the Commerce Clause of the U.S. Constitution. The Court said:

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[24] American Elec. Power Service Corp., 28 FERC ¶61,228 (1984).

> The "public interest" which prompted Congress to empower the FERC to regulate facilities used for the transmission of electric energy from one state for consumption in another and the "public interest" which the FERC must consider in deciding whether to approve or disapprove a contract affecting a rate or charge for any such transmission is the collective interests of the fifty states which is not only greater but may be quite different from the interests of the public in any one state [citation omitted][26].

The court also noted that "denial of cost recovery would in effect nullify an agreement which the FERC might approve as being in the national interest".

The Public Utilities Commission of Ohio also appeared in the FERC proceedings in opposition to the Agreement. In a recent retail rate case, the Staff of the Ohio Commission and the Ohio

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[25] Appalachian Power Co. v. Pub. Serv. Comm'n of West Va., 614 F.Supp. 64 (S.D.W.Va. 1985), aff'd, 770 F.2d 159 (4th Cir. 1985).

[26] Appalachian Power Co. v. Pub. Serv. Comm'n of West Virginia, 630 F.Supp 656 (S.D. W.Va. 1986). This case is on appeal to the Fourth Circuit, where the FERC has filed an amicus brief in support of AEP's position.

Consumers' Counsel recommended that Ohio Power's payments under the Transmission Agreement be disallowed, as was attempted in West Virginia. In its order issued July 9, the Ohio Public Utilities Commission rejected its staff's recommendation and allowed the pass-through of the transmission payments to Ohio Power's retail customers. In doing this the Ohio Commission recognized the controlling effect of the Supreme Court's decision in the *Nantahala* case.

The threat posed by a state commission's refusal to recognize FERC's jurisdiction over the Transmission Agreement is not limited to instances in which operating companies must make payments under the Agreement. A similar risk exists in the states which *receive* payments. A state commission might decide that the recipient company is not getting *enough* money fast enough under the Agreement, and in setting retail rates pretend that the "proper" level of payments is available to the company to meet its total revenue requirements. This is not a matter of speculation -- it has, in fact, already taken place. Kentucky Power Company is a surplus company under the Transmission Agreement, and therefore receives payments from the deficit members. In a December 1984 rate order, the Kentucky Commission excluded from Kentucky Power's rate base the amount of its investment in EHV facilities in excess of its MLR share of the total System investment. It reasoned that the costs of EHV facilities in excess of Kentucky Power's MLR share should be the responsibility of the other pool members. Of course, under the Transmission Agreement, the other pool members *will* reimburse Kentucky Power for its investment in excess of its MLR share. However, such a reimbursement will occur, in full, only after the five-year phase-in. In effect, the Kentucky Commission, for retail rate-making purposes, is attempting to ignore the phased-in nature of the Agreement. The AEP pool members also challenged the Kentucky Commission's action in federal court, but the federal courts, thus far, have abstained from exercising jurisdiction over the question, as will be more fully explained below.

It is evident from the positions taken by the West Virginia and Kentucky Commissions and the Ohio Commission's Staff and Ohio Consumers' Counsel that interstate pooling agreements, such as the Transmission Agreement, cannot practically be subject to the fragmented state regulation that would result from the enactment of Senate Bill 1149. The Transmission Agreement merely provides for an equitable sharing of costs of the EHV transmission system among the AEP System Companies operating in different states. While it provides for payments among the members, the AEP System, as a whole, does not realize any gain from such transfers -- and should not suffer any loss. Yet if the paying states can disallow retail rate recovery of the payments under the Agreement and the receiving states, which feel that they are not receiving enough money fast enough, can prohibit the companies from recovering the so-called "shortfall" from retail customers, the AEP System would incur enormous losses of revenues. (The United States Supreme Court, in its Nantahala decision, referred to this type of "shortfall" as "trapped costs".) Obviously, no rational electric utility would enter into an interstate coordination agreement under such circumstances. Simply put, when the question is how to divide a pie among several states, each state cannot logically be given the right to determine the size of its own slice. There must be a strong and impartial federal umpire (FERC) to make that call; and it is the job of the federal courts to see to it that that call is observed by the state agencies.

The AEP System also has encountered similar difficulties in connection with the allocation of costs of its generating plants under the Interconnection Agreement. The problem experienced by AEP in this regard is very much like that experienced by the Middle South companies in connection with their Grand Gulf nuclear plant. In AEP's case, the plant involved is the 2600-MW Rockport plant, located in southern Indiana. This plant, consisting of two 1300-MW coal-fired units, is the latest to be added to the AEP System. Unit No. 1 went into service in 1984, and Unit 2 presently is scheduled for service by 1988. Because of AEP's policy of building large, highly efficient generating units, which, as explained earlier, is made possible because of the AEP pooling arrangement, Rockport has been built at a very low relative cost. For example, Rockport Unit No. 1 cost about $855 per kw to build, while contemporaneous coal-fired plants cost in the neighborhood of $1,250 to $1,500 per kw. Though Rockport's generating capacity is less expensive than most other contemporaneous coal plants, it is considerably more expensive than the older generating capacity on the AEP System which was constructed during the past two or three decades. The average embedded cost of all steam generation on the System is currently about $320 per kw.

Over the years, the AEP System has followed the practice of rotation of ownership of generating plants among the pool members. Rockport was and is being built by Indiana & Michigan Electric Company (I&M) with financing assistance by AEP Generating Company, but in the late 1970's it was determined that Kentucky Power should own 15% of the plant. I&M and Kentucky Power were both deficit in supplying generating capacity to the pool. Kentucky Power, for its part, is proportionally the most deficit member. It has not added generating capacity in almost 20 years, and its existing capacity is inadequate to meet its own customers' requirements with an adequate reserve margin. As a result of these facts, coupled with its membership in the AEP pool, Kentucky Power's electric rates are among the lowest in the nation. Kentucky Power first sought permission from the Kentucky Public Service Commission to own directly 15% of the Rockport plant. Over a period of eight years, the Commission changed its mind several times as to whether permission for such ownership would be granted. Ultimately, it denied permission for Kentucky Power to own 15% of the plant.

The Interconnection Agreement provides that pool members can acquire needed capacity either through ownership or through purchases of capacity from affiliated or foreign companies. This provision was added, in 1975, to help alleviate capacity imbalances among the members and to provide for the equitable sharing of the costs of new generating capacity. Under this provision, Kentucky Power entered into a Unit Power Agreement to purchase 15% of the output of the Rockport plant. The Unit Power Agreement was accepted for filing by FERC and allowed to go into effect on the commercial operation date of Rockport Unit No. 1. However, in the same rate order in which it denied Kentucky Power's recovery of EHV transmission costs, the Kentucky Commission also denied the Company's recovery of costs incurred under the Rockport Unit Power Agreement. It based its denial (and its earlier rejection of 15% direct ownership) on the theory that Kentucky Power has an "option" under the AEP Interconnection Agreement not to add needed generating capacity, but instead to sponge off the other pool members indefinitely. While this theory lacks both logic and equity, it is a device to shield Kentucky customers from the higher cost of new plant, and to push those necessary costs off onto the AEP pool members and their customers in other states. The question of whether the AEP pool agreement can indeed be interpreted to allow such an absurd result is currently pending before the FERC in a declaratory order proceeding.[27] In the meantime, however, Kentucky Power is losing over $23 million per year in costs incurred under the Unit Power Agreement, which it must pay, as a FERC rate, but cannot, under the Kentucky Commission's order, recover from its retail customers. In the words of the United States Supreme Court in Nantahala, these are "trapped costs".

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[27] Kentucky Power Co., FERC Docket No. EL86-10-000.

Kentucky Power and the other AEP pool members sought to enjoin the Kentucky Commission's order in federal district court, but the district court abstained from exercising jurisdiction, and deferred to the Kentucky state courts for resolution of the matter. The AEP Companies appealed the district court's abstention to the Sixth Circuit Court of Appeals, but the Sixth Circuit upheld the district court's abstention.[28] We filed last week a petition for writ of certiorari with the United States Supreme Court seeking review of the Sixth Circuit's decision.

We believe that Senate Bill 1149 would render inoperative the provision of the AEP Interconnection Agreement that allows generating capacity to be purchased and sold among the members through unit power agreements. This provision, in turn, is necessary to assure an equitable sharing of the costs of new capacity among the members. Surely, many states would like the opportunity to claim, as has Kentucky, that the pool members in other states should bear the higher cost of new generating capacity. But a power pool cannot operate in such a manner. The disintegration of the pool, which would be a logical consequence of such legislation, would be unfortunate from the standpoint of the nation as well as AEP's customers. As with the Transmission Agreement, preemptive federal regulation over the Interconnection

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[28] American Elec. Power Inc. v. Kentucky Pub. Serv. Comm'n, U.S. Ct. of Appeals, 6th Cir., Civil Action No. 85-5129, Opinion, March 24, 1986.

Agreement, particularly as it governs the allocation of the costs of power supply facilities among states, is absolutely essential.

The AEP System does not seek lenient regulation, but only impartial regulation. The Public Utility Holding Company Act and Part II of the Federal Power Act were enacted as companion legislation, and at least one purpose of this legislation was to assure regulatory scrutiny of wholesale power transactions among holding company affiliates, which transactions had been rendered unregulated by the Supreme Court's decision in Attleboro[29]. The FERC, as a matter of law and policy, closely scrutinizes transactions among affiliated companies.[30] State commissions, in their role as intervenors in FERC proceedings, can raise any issue that they feel has a bearing upon the justness and reasonableness of the proposed wholesale rate. There is no basis upon which to presume that the FERC will be any less diligent in protecting the public interest than a state commission.

Part II of the Federal Power Act was enacted in recognition of the rapid development of the electric utility industry along lines that transcend state boundaries[31]. Certainly, the interstate character of power flows is more pronounced today than it was in 1935. In fact, the electric utility industry is much more highly interconnected and much more of a national business today than it was fifty years ago. Indeed, there is a substantial body of fresh authority to the effect that one future trend in the electric utility industry will be toward consolidations of the many existing systems into larger, stronger and fewer systems and that such integration will result in improved efficiency, and thus is in the overall public interest. I would point out, however, that insofar as this desirable trend involves the consolidations of utilities across state lines, it would be seriously discouraged by measures such as S. 1149 and by state actions involving economic protectionism, i.e., refusing to recognize and accept their proper share of the higher cost of new facilities and trying, instead, to shunt off to utilities and their customers in other states an unfair portion of such higher costs.

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[29] See Louisiana Power and Light Co., 13 FERC ¶61,221 (1980).

[30] See, e.g., Pennsylvania Power & Light Co. v. F.P.C., 139 F.2d 445 (3d Cir. 1943).

[31] Senate Report 621, 74th Cong., 1st Sess. (1935), p. 17.

"The necessity for federal leadership in securing planned coordination of the facilities of the industry which alone can produce an abundance of electricity at the lowest possible costs . . ."[32] is, therefore, more evident now than it was in 1935 when Congress enacted Part II of the Federal Power Act. To revert to state regulation of interstate power transactions would be to turn back the clock to the early days of the century, when electric systems operated as isolated, essentially local businesses. Politically, it would constitute a return to the unworkable Articles of Confederation which preceded the Constitution of the United States.

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[32] Id.

Senate Bill 1149 should not be enacted into law.

Senator BUMPERS. Thank you, Mr. Dowd.

Let us see, according to the list here, Mr. Barr is next.

STATEMENT OF JOHN W. BARR, MANAGING DIRECTOR, MORGAN STANLEY & CO. INC.

Mr. BARR. Mr. Chairman, thank you for accommodating my comments.

I would like to make two simple points. If anything is clear from today's hearing, it is that S. 1149's sponsors believe that Middle South Energy was created to circumvent State regulation. If I may paraphrase a few of the phrases used, there has been a rush to the courthouse steps, FERC has never met an imprudent plant, and FERC has never met a utility it did not like. In short, FERC is assumed to have been the regulation of choice.

The point I want to make is that that was certainly not the view of FERC in 1972, 1973, and 1974 at the time that Middle South Energy was being designed and created. At that time, FERC was viewed and was rated by investor agencies as a strictly average regulatory environment compared to State regulators with the added negative that FERC cases often took 2 to 3 years to be completed, which created substantial additional investor risk. There was no reason to expect that FERC would be better in the years that followed than Arkansas, Louisiana, or Mississippi regulation.

We should remember that the regulatory jurisdiction over Grand Gulf was not established last month or last year. It was established over 12 years, and it has not changed since. So, in our view the motive for an elaborate regulatory circumvention simply was not present in 1974.

In fact, I wonder if FERC had turned out to be the other kind of regulatory environment, if from an investor's standpoint it had been worse than the States instead of better than the States, we could ask if S. 1149 would be introduced and if these hearings would be occurring today.

The second point I would like to comment on, Mr. Chairman, is your question as to whether investors would favor the participation by the State regulator in the construction process in the decision to build at the outset of a powerplant.

Investors generally dislike uncertainty, and they dislike risk. Anything that sets out the ground rules clearly on an investment decision is positive. I think that such participation or preagreement to include State regulatory bodies could be of help, but I want to be clear in what way it could be of help.

I do not believe that that participation by State regulators would necessarily or even probably result in better decisions. I do not a priori assume that the economic forecasters of the State regulators are better than the economists on the staffs of the public utilities who are making those long-term planning and construction decisions.

It does have the benefit that it increases the probability that we will all be either right or wrong together, that the regulators and the company managements, if they participate in that build decision at the outset, will have less of an easy time 10 years later taking a different position on what things look like at the time the decision to build was made.

I believe, Mr. Chairman, you have offered as an advantage of that strategy that it might reduce regulatory second guessing. I would point out that investors have built up substantial skepticism about regulatory second guessing, and in fact it is one of the principal investor risks that we can see present in the utility stock and bond markets today.

You mentioned that future commissions cannot be bound by past commissions, and in fact investors are very much aware of that.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Barr follows:]

PREPARED STATEMENT OF JOHN W. BARR

My name is John W. Barr. I am a Managing Director of Morgan Stanley & Co. Incorporated, and I am in charge of my firm's financing and advisory activities with the public utility industry. (See Attachment for my background.) Morgan Stanley is a leading investment banking firm in the underwriting and placement of securities for corporations. We provide investment banking services to a broad group of client companies within the electric, gas and telephone sectors of the utility industry, including Middle South Utilities.

Over the past ten years, Morgan Stanley has managed or co-managed over $1.8 billion of securities on either a competitive or negotiated basis for MSU or its operating electric company subsidiaries. In addition, over the last three years, Morgan Stanley has provided the System with extensive financial advice.

The purpose of my comments is to address the substance of S.1149 which would grant state regulatory authority to prevent the pass-through of costs between companies of the same public utility holding company system if the state commission had not first approved the construction of the generating unit upon which the rates are based. I understand this legislation is intended to affect primarily Middle South Utilities' (MSU) Grand Gulf nuclear plant whose rate requirements have been established by the FERC. It could also negatively impact other electric utility holding companies by allowing states to disrupt long-standing power pooling arrangements, which are central to the basic operation of holding companies. In the extreme, this legislation could lead to the loss of the advantages of the holding company structure.

My comments to this Subcommittee will discuss the decision by MSU to form Middle South Energy (MSE) as the financing vehicle for the Grand Gulf Station. Specifically, I will discuss the use of special purpose financing for major projects and why the MSE structure was appropriate for the Grand Gulf Project. I will also discuss investors' views of federal versus state regulation when MSE was formed.

Special Purpose Financing for Major Projects

The use of special purpose entities to construct and finance major projects is a concept well-founded in financial theory. This concept, commonly called "project finance," has been used over a long period of time for a wide range of major projects in the industrial and energy sector of our economy. Although there are many variations to project finance, typical features include large size projects and financing based on contracts or agreements with other creditworthy entities. In practice, the formation of such entities has often proved to be the best, most logical and most economical way to own, construct, and finance major capital-intensive projects.

The energy company concept has precedent in utility finance. At least five other energy companies had been established by electric utility companies for the construction and financing of large, new generating additions prior to the establishment of MSE. The first of these was Yankee Atomic Company, formed in 1954 by eleven New England electric utility companies to construct and own the Yankee Atomic Nuclear Unit. This was followed in 1962 with the formation of Connecticut Yankee Power Company (to construct and own the Connecticut Yankee Atomic Nuclear Unit) and in 1966 with the formation of both Vermont Yankee Nuclear Power Corporation and Maine Yankee Atomic Power Company. The other similar energy company was Indiana & Michigan Power Company formed in 1971 by Indiana & Michigan Electric Company to finance a nuclear generating project.

My understanding is that the purpose and structure of each of these energy companies was similar to that of MSE in that they were formed to finance the construction of large electric generation projects. I believe energy companies can often be an appropriate financing structure for such projects.

2. MSE Structure for the Grand Gulf Project

It is my view that MSU's formation of an energy company, namely Middle South Energy, was a prudent and reasonable vehicle to finance the construction of the Grand Gulf Project and, in fact, was the most appropriate alternative available to MSU at the time the decision was made to build this project. There were three principal financing alternatives available to the Middle South System at the time of construction of Grand Gulf:

Alternative 1:	100% ownership and financing of Grand Gulf by one subsidiary.
Alternative 2:	Joint ownership by two or more of the MSU subsidiaries with financing provided by each subsidiary as construction progressed, on the basis of its ownership.
Alternative 3:	100% ownership and financing by an energy company based on power purchase contracts with the MSU operating subsidiaries which would ultimately purchase the energy.

I would like to discuss each of these alternatives.

Alternative 1: Sole Ownership

This alternative for Grand Gulf's construction and financing would have been for one of the operating companies to own and finance 100% of the Project. Until the Grand Gulf Station, this had been the customary financing structure for the Middle South Companies.

Arkansas Power & Light (AP&L) thus built, financed and owned Arkansas Nuclear One, Units No. 1 and 2, and Louisiana Power & Light (LP&L) did the same for the Waterford 3 Station. When it was determined that another nuclear project was required and the Grand Gulf site was chosen as the best location, it would have been the logical choice for Mississippi Power & Light Company (MP&L) to construct, finance and own this station. In 1972, because of its size, MP&L alone would not have been able to carry the financing burden of even the first unit of this Project. At this time, MP&L had inadequate revenues and total assets and the project was clearly too large relative to MP&L's financial capacity. In fact, it would have been impossible for any of the operating companies, considering the other construction activities currently underway, to finance on their own credit a project of this magnitude in the time frame of the proposed construction schedule. Total ownership by one operating company was clearly not the appropriate mechanism.

Alternative 2: Joint Ownership

Joint ownership of Grand Gulf by all or some of the operating companies was another possible alternative for Grand Gulf. This alternative would have required each operating company to provide financing as construction progressed on the basis of its ownership percentage. Based on traditional practices, this financing would have been through first mortgage bonds, preferred stock and common stock (sold to MSU) along with a limited amount of unsecured debt. In order to issue bonds and preferred stock, the indentures and charters of the operating companies, respectively, require minimum earnings coverages. Specifically, for the issuance of additional first mortgage bonds, the mortgage indentures of these companies require that minimum earnings coverage must be at least twice the pro forma annual bond interest; the charters of these companies require that for the issuance of additional preferred stock, earnings coverage must be at least one and one-half times the pro forma annual interest charges and preferred dividends. Until the beginning of the large construction programs, these coverage requirements had not been a problem for the operating companies. By 1974, however, deteriorating coverage ratios were approaching these limits. Specific coverages, by subsidiary, were as follows:

	AP&L		LP&L		MP&L		New Orleans Public Service	
	Bonds	Preferred Stock	Bonds	Preferred Stock	Bonds	Preferred Stock	Bonds	Preferred Stock
1973	2.51	1.88	3.36	2.06	2.36	1.99	4.31	2.37
1974	2.18	1.94	2.60	1.82	2.48	1.89	1.73	1.30

It would have been impossible for these companies to support the large amounts of financing necessary for Grand Gulf on top of the financing required for ongoing projects for which they were responsible. It would not have been prudent financially for any combination of the operating companies to undertake a project of this magnitude. Since it was strongly believed by all of the operating companies that the Grand Gulf project was needed to meet the projected future load, a different structure was necessary to finance Grand Gulf.

Alternative 3: Energy Company

The energy company concept offered important advantages over the previously discussed two alternatives by increasing the financial flexibility of the MSU companies. By this, I mean that the formation of MSE increased the financial ability of the MSU System by presenting a solution to the financial constraints resulting from the operating subsidiaries' indenture and charter restrictions. As the 1970's progressed, this proved especially important because MSU's largest subsidiaries, LP&L and AP&L, experienced severe financing difficulties. As early as June 1975, LP&L announced the cancellation of two nuclear units (the St. Rosalie Station) and AP&L announced the deferral of two coal-fired units (the White Bluff Station) because their earnings would not support the originally planned construction program. Construction at AP&L's deferred White Bluff Station had to be shut down for about 22 months, as the result of financial problems emanating from the inability of AP&L to obtain the rate relief they needed in order to sell securities. These financial difficulties, as well as additional problems in later years can be seen in the earnings coverage, with no Grand Gulf financing, for the 1975-1976 and 1978-1980 period for these two companies.

	AP&L		LP&L	
	Bonds	Preferred Stock	Bonds	Preferred Stock
1975	1.80x	1.38x	2.45x	1.81x
1976	1.96	1.54	2.24	1.67
1977	2.63	1.83	2.39	1.68
1978	2.39	1.91	1.94	1.63
1979	1.56	1.70	1.71	1.36
1980	1.96	1.32	2.53	1.56

It should be noted that the coverage ratios shown are actual ratios, not pro forma ratios, as required by the indenture and charter for issuance for new first mortgage bonds and preferred stock. Pro forma ratios would be lower to reflect the interest and fixed charges associated with proposed new issues of securities. These ratios indicate that for several years (1975, 1976, 1979 and 1980 for AP&L and 1978 and 1979 for LP&L), first mortgage bonds could not be issued by the two largest MSU operating companies for their ongoing construction requirements. It would have been impossible for these companies to issue ever more first mortgage bonds and preferred stock to finance Grand Gulf during this period. Additionally, the MSU operating companies were limited by terms of their indenture in the amount of unsecured debt which could be outstanding so it would not have been possible to replace the necessary amount of first mortgage bonds or preferred stock with unsecured debt. In short, there would have been no way that the MSU companies could have financed Grand Gulf, even at the then projected costs, by the use of existing financing methods.

As a second advantage, by using the energy company structure, the MSU companies were able to finance with more debt and less equity than if this financing had been done by the operating companies themselves. Specifically, MSE's minimum target capitalization ratios, as approved by the Securities and Exchange Commission, require that only 35% of MSE's capital be in the form of equity and the remainder (65%) long-term debt. (No preferred stock was authorized.) In addition, short-term debt equal to as much as 5% of total capitalization is permitted. In contrast, a more balanced capitalization for the operating companies is generally required by the SEC under the Public Utility Holding Company Act of 1935 and by the financial markets. This would have likely limited total debt (long and short-term) to no more than 55-60% with the remainder common and preferred stock. The increased leverage of MSE resulted in a lower overall after-tax cost of capital for the project than if the financing had been done by the operating companies.

An additional benefit of the energy company, as seen at the time MSE was established, was that this structure allowed the construction of Grand Gulf to be financed using lower-cost short-term bank funds rather than funds from long-term capital markets (debt and equity) which traditionally carried higher costs of capital. Historically, the "yield curve" has been positive--i.e., long-term rates are higher than short-term rates. During all but short periods of unsettled markets, this is the traditional relationship between long and short-term interest rates reflecting the fact that investors require an interest rate premium to compensate them for tying up their funds for a longer period of time. This positive yield curve is the relationship which existed for most of the four year (1970-1973) period prior to the establishment of MSE.

There was an additional benefit from financing Grand Gulf with short-term funds. Generally, the investment risks of construction, financing and completion of a major project such as Grand Gulf are viewed as greater than the investment risks which exist following completion of such a project. Rather than pay for these higher risks in the cost of capital from the beginning of construction, MSE's initial plan was to refinance the short-term construction funds with long-term funds upon completion of Grand Gulf. Theoretically, MSE's long-term financing costs would then be lower because investors would no longer require compensation for the construction risks which would then be behind the Company. The companies thus expected to be able to reduce financing costs over the life of Grand Gulf through the MSE structure.

An additional reason for using the short-term market was the fact that the long-term capital markets were in disarray at the time MSE was established. For the first time in modern financial history, many utilities, epecially lower quality issuers, were unable to finance in the long-term debt market and the relative financing costs and terms for the electric utility industry, in general, were unattractive. It was hoped that more normal conditions in the capital markets would return in the future. Thus, at this time, it was reasonable to believe that short-term bank financing, even if at historically high costs, was advantageous.

In summary, I believe that formation of MSE was the most reasonable and appropriate structure for the financing of the Grand Gulf Project, given the information known and alternatives available at the time. MSE's financing goal has been to insure that capital is available when needed, consistent with the lowest costs available in the markets and the Company's overall financial objectives. I believe that MSE has been successful in achieving this goal. Its financings have provided adequate capital for Grand Gulf Unit 1 with some margin for contingencies. At no time did the inability to attract capital impede the construction schedule for Grand Gulf Unit 1. Any increased costs were due primarily to delays in completion of construction, not to the structure of MSE. Had this structure not been used, the MSU system would not have had the financing capacity to complete Grand Gulf and the project would, in all likelihood, have been further delayed, deferred or cancelled due to financial contraints.

Federal versus State Regulation

It has been suggested by some that MSE was formed by MSU as a way to avoid state regulation. I have no reason to believe that this was the case. As discussed above, the energy company concept was the best alternative for the Grand Gulf project given the financial constraints facing the MSU System in the early 1970's. Generation from energy companies is sold at wholesale for resale to operating utilities. By law, such sales are regulated by the Federal Energy Regulatory Commission (FERC), formerly the Federal Power Commission (FPC). Thus the use of this structure necessarily brought MSE under the jurisdiction of the FERC.

At the time of the decision to form MSE, there was no reason for MSU to expect FPC regulation to be more favorable than the regulation from the states which regulated their operating companies, namely Arkansas, Louisiana and Mississippi. In the early 1970's, regulation in these states was generally considered reasonable by investors, although there had been little need for rate requests to test these regulators. Regulatory law in these states provided for constructive principles for rate establishment, e.g., rate decisions in 5 - 12 months, and current test years for determinations of rate base.

On the other hand, FPC regulation at this time was considered no better than average compared with state regulation. A major negative of FPC regulation was that rate cases took an inordinately long time to be decided. Although at least a portion of requested amounts could be collected subject to refund after 6 - 12 months, it was not unusual for rate cases to require 2-3 years for final decision. This created the potential for significant refunds if an amount less than the interim rate increases was ultimately allowed. It also frequently necessitated the "pancaking" of rate cases, i.e., the filing of one case when another was still pending. The result was a regulatory enviroment with significant uncertainties for utilities.

In later years, this relative evaluation of the state versus federal regulation changed, with MSU's state regulators becoming more stringent and the FERC reducing its regulatory lag problem. Nonetheless, FERC regulation for MSE has been strict and onerous, as reflected in the long drawn-out proceeding for establishment of rates for the Grand Gulf project. This process required a considerable amount of hearings and deliberation by the FERC and the ultimate decision, which was significantly less than MSE's initial request, represented a sharing of the burden of Grand Gulf, in an effort to balance the interests of all parties.

Nonetheless, I have no reason to believe that regulatory considerations, either current or future, were a primary determining factor in the decision to form MSE. Rather, I believe the goal was to establish the best structure to provide for the construction and financing of Grand Gulf. As stated above, I believe that this appropriate structure was Middle South Energy. Based on the appropriateness of this decision, there is no support for federal legislation which would alter the method of regulation of generation produced by the Grand Gulf Station.

Senator BUMPERS. Thank you, Mr. Barr.

Mr. Greenman.

STATEMENT OF FREDERIC E. GREENMAN, VICE PRESIDENT AND GENERAL COUNSEL, NEW ENGLAND ELECTRIC SYSTEM

Mr. GREENMAN. Thank you, Mr. Chairman.

My name is Frederic E. Greenman. I am vice president and general counsel of New England Electric System. Our interstate utility holding company system is structured differently than most. We have a single wholesale company that provides generation and transmission for three retail affiliates serving customers in three States, Massachusetts, Rhode Island, and New Hampshire.

Sales by the wholesale company to the retail affiliates are regulated by FERC. The retail companies' rates are regulated by the State commissions. This mix of Federal and State regulation, we think, has an outstanding track record in our system. It is comprehensive. There are no regulatory gaps. There is no overlap. It is efficient. In short, we believe it works.

Mixed State/Federal regulation has produced low rates to customers and a financially sound utility system. The best evidence is the fact that our retail rates to consumers in the three States we serve are among the lowest in New England. These good results have been produced by the current blend of State and Federal regulation. The benefits of this blend, we believe, would be threatened by enactment of S. 1149. The bill would compound the number of regulatatory proceedings that address a single issue.

Using our system as an example, we pursue least cost power supply strategies and projects throughout the region, and by region I mean, of course, New England and in Canada. Preapproval of each project by our three New England rate commissions could make an already complex and difficult licensing process even more difficult and perhaps impossible.

Yet, absent such preapproval, we would litigate project costs before FERC and then face the prospect of having the three State commissions make a determination not to take into account all or part of Federally-approved rates in establishing retail rates. Four separate rate cases addressing one issue would, at best, be inefficient. In all likelihood, it would also be unfair.

Since State commissions quite naturally strive to keep costs to local customers down, the result is likely to be that some wholesale costs, even though found to be just and reasonable by FERC, would nevertheless be disallowed. This result would ultimately undermine interstate cooperation within utility systems and among utilties generally. Interstate power pooling and joint development of generation, we believe, would be discouraged. The reliability and economic benefits associated with interstate transactions would be threatened.

In short, the present blend of Federal/State regulation works well in our system. It produces efficient service for our customers and allows us to recover the just and reasonable cost of that service in our rates, no more and no less. It is fair to customers and to investors.

S. 1149 we believe would unwisely abandon the use of FERC as an impartial Federal arbiter of competing State interests, create conflict, produce duplicative, ineffective regulation, and invite disallowances of the just and reasonable cost of providing service. Ultimately, it would produce less reliable service to customers at higher cost.

Thank you very much.

[The prepared statement of Mr. Greenman follows:]

UNITED STATES SENATE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

SUBCOMMITTEE ON WATER AND POWER

STATEMENT OF

FREDERIC E. GREENMAN

VICE PRESIDENT AND GENERAL COUNSEL

NEW ENGLAND ELECTRIC SYSTEM

JULY 23, 1986

New England Electric System Companies
25 Research Drive
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UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON WATER AND POWER

STATEMENT OF FREDERIC E. GREENMAN
JULY 23, 1986

Mr. Chairman and Members of the Subcommittee:

My name is Frederic E. Greenman. I am Vice President and General Counsel of New England Electric System (NEES). The NEES companies provide electric service to over 1.1 million customers in Massachusetts, Rhode Island, and New Hampshire.

I appreciate this opportunity to appear before the Subcommittee to provide information that I hope will be useful in your consideration of S. 1149. This bill would have a major impact on the current system of Federal and state regulation of electric utility rates. In my comments today, I plan to:

- First, provide a brief review of the current allocation of responsibilities among Federal and state governments for regulating electric rates;
- Second, use our organization, NEES, as an illustration of why the existing allocation of responsibilities works well and serves the public interest; and
- Third, explain how S. 1149 would in my opinion undermine the existing system.

I. BASIC PRINCIPLES UNDERLYING THE CURRENT ALLOCATION OF REGULATORY RESPONSIBILITIES BETWEEN FEDERAL AND STATE GOVERNMENTS

A. Current Federal Laws

Congress enacted Part 2 of the Federal Power Act together with the Public Utility Holding Company Act as a single piece of legislation designed to bring interstate utility systems under effective Federal control. The Supreme Court's Attleboro decision under the Commerce Clause had limited the states' constitutional authority to regulate interstate utility transactions and had left a major gap in utility regulation.[1] In response, Congress enacted a careful and comprehensive system of Federal regulation to control the affiliate transactions of interstate utilities.

The responsibility for regulating corporate organization and affiliate contracts was delegated to the Securities and Exchange Commission (SEC) under the Public Utility Holding Company Act. Among other things, the SEC was given authority to regulate construction and service transactions between affiliates within the holding company system. However, sales of electricity between affiliates were excluded from the SEC's responsibilities under the Holding Company Act and made subject to FERC's exclusive jurisdiction under Part 2 of the Federal Power Act.

Under Part 2 of the Federal Power Act, FERC's jurisdiction extends only to sales of electricity at wholesale in interstate commerce. State commissions retain authority over retail sales to customers. However, the states must recognize as reasonable the wholesale power costs found to be just and reasonable by the Federal agency. The result is a blend of state and Federal authority, each with exclusive responsibility in its individual area. On an overall basis, the entire interstate utility system is regulated effectively, without regulatory gaps or duplication. The SEC regulates affiliate transactions, FERC regulates wholesale rates for sales between affiliates, and the states regulate retail operations and rates to ultimate customers.

B. The Regulation of the NEES System

The existing regulatory framework makes sense. The NEES System provides a good example of how well it can work. NEES is an integrated public utility holding company system regulated by the SEC under the Holding Company Act. The electric operations of its subsidiaries are divided along jurisdictional lines. A single wholesale company, New England Power Company (NEP) provides the generation and transmission services for its three retail affiliates, each operating in separate states. NEP's wholesale rates to the retail affiliates are regulated by FERC under the Federal Power Act. In turn, the rates the three retail companies charge to ultimate customers are established by their respective state commissions. The regulation of system activities is comprehensive and complete. Yet, the clear jurisdictional lines drawn between state and federal authorities minimize duplicative regulation and inconsistent orders.

The Federal-State system of regulation has allowed us to achieve low rates for all our customers. Our planning is done on a System-wide basis and is designed to produce least cost power supplies to all retail customers on the System, whether they are located in Massachusetts, Rhode Island, or New Hampshire. To achieve the least cost plan, NEP has pursued power supplies across New England and into Canada. FERC's interstate perspective has allowed and encouraged a System-wide approach to planning and power supply.

The states also have an active role. They regulate directly the operations of the retail affiliates. The states also actively participate in FERC proceedings and aggressively assert their interests. The Federal forum allows the parties to resolve their conflicts in a single proceeding and provides a neutral arbiter for unresolved issues. All activities are fully regulated, but issues are litigated only once. The process works well: the NEES System's rates to customers are among the lowest in New England. In short, Federal-state regulation of holding companies can work to produce effective regulation, low rates, and financially sound, efficient utility systems.

II. S. 1149 WOULD UNDERMINE THE EFFECTIVE REGULATION OF INTERSTATE UTILITY SYSTEMS

S. 1149 would undermine the careful, comprehensive system of Federal and state regulation. It would allow state commissions to ignore FERC proceedings and disallow purchased power expense found "just and reasonable" by the Federal government whenever the state commission has not approved the construction of any generating unit reflected in the wholesale rate. The bill is not a technical amendment to the Federal Power Act. It is a fundamental, sweeping change that prevents the implementation of longstanding Federal policy and the effective regulation of holding company systems.

A. S. 1149 Would Create Regulatory Conflicts

Under S. 1149, a state commission would be free to disregard the FERC-filed wholesale rate whenever it has not approved the construction of any generating unit in the wholesale affiliate's generating mix. The freedom to ignore the Federal decision would depend on the local commission's actions and authority under state law. On the NEES System, the state rate commissions do not have jurisdiction to approve construction of generating units and, thus, would be free to ignore the wholesale rates.

The bill invites conflict not only between state and Federal regulation, but also among the various state jurisdictions. State commissions have primary responsibility to retail customers located within their individual states. To achieve the lowest costs for their own ratepayers, state commissions may reject costs found reasonable by FERC, attribute higher costs to their neighbors, or keep lower cost power supplies for themselves.

These conflicts among the states formed the basis for the Supreme Court's Commerce Clause holdings that prohibited state regulation of wholesale interstate transactions and led to the passage of Part 2 of the Federal Power Act. For example, the Attleboro case itself stemmed from Rhode Island's attempt to reduce local rates by increasing the utility's rates to a wholesale customer in Massachusetts. The Supreme Court found that the Commerce Clause prohibited the attempt. More recently, the Court has held unconstitutional New Hampshire's attempt to prohibit the export of low-cost hydropower to the other New England states.[1] And just last month, six decades after Attleboro, the Court struck down North Carolina's rejection of costs it claimed should be allocated to a customer in Tennessee.[1]

The potential for inconsistent regulation allowed by the bill can undermine integrated planning for all customers on the interstate System. For example, under NEESPLAN II, our long-range corporate plan, we engage in balanced planning on a System-wide basis to reliably serve all retail customers at the lowest possible cost. An array of programs and commitments is undertaken to meet these objectives. The projects may be located in different states and may be undertaken by different affiliates, but they are all designed to meet the needs of the entire System as efficiently as possible.

For the process to work, regulation must evaluate these programs on a System-wide basis. Congress should not encourage local regulation that attempts to minimize costs for one affiliate without reference to the needs of the other utilities on the integrated System. Unless the action is consistent with the needs of the overall System and leads to increased efficiency for the integrated network, the short-term savings to the local utility will be illusory, and customers as a whole will be worse off.

A similar problem is presented by interstate cost allocations. Several methods are always available to allocate wholesale costs among the individual states. Under the Federal Power Act, FERC must select a method that is just and reasonable to all states on the System. However, if S.1149 were enacted, each state would have the freedom to disregard the FERC finding and choose the method that produces the lowest rates for its retail customers. The product of all these "reasonable" allocations would be a totally unreasonable result that would discourage the interstate transactions which are necessary to produce reliable and economic power supplies for all retail customers on the holding company system.

Exclusive Federal jurisdiction avoids these problems by engaging in a single System-wide review of interstate activities. FERC's jurisdiction extends beyond the bounds of a single state. Its concerns properly focus on the needs of the entire system and the most efficient methods to meet those needs regardless of state boundaries. FERC properly applies an interstate perspective to an interstate utility system. It focuses directly on the efficiency of the System as a whole, rather than a single component of that system.

B. S. 1149 Would Lead to Multiple Regulation of the Same Costs

S. 1149 would foster multiple regulation of the same wholesale costs. Utilities and intervenors, including the states, would litigate at FERC the cost of providing wholesale service and the allocation of those costs among the affected states. Then the process would start all over at each retail rate commission. Each commission would have Congressional blessing to investigate the same costs allowed by FERC, and to reach different and conflicting results.

Under S. 1149, NEP's wholesale rate filings could be fully litigated in four separate hearings before four separate rate commissions. The additional expenditure of resources in the rate setting process would not produce better decisions or fairer rates. The opposite would result. Because states would not be bound by the Federal rate, the bill seriously undermines FERC's decision-making process. The bill would also result in incomplete records before the state agencies, who would not hear the views of neighboring states and would not have direct jurisdiction over the selling utility.

A single neutral arbiter is required to assure fair rates and objective allocations among the states and to provide a definitive answer for all parties. Under the Federal Power Act, FERC performs that role. The Federal forum resolves the controversy in a single proceeding at which all parties are represented. The Federal tribunal's decisions are based not on the interests of the individual states, but on a showing that the rate and cost allocation is fair, efficient, and "just and reasonable" under the Federal Power Act. Lower retail rates in an individual state are neither sufficient to make this showing nor a proper basis for the Federal decision. Rather, the rates must be just and reasonable for the utility and all of its customers.

C. S. 1149 Would Lead to the Underrecovery of the Just and Reasonable Costs of Providing Service

The inevitable result of the complex and inconsistent system of regulation authorized by the bill would be an underrecovery of the cost of providing interstate, wholesale service to customers. Under the bill, FERC would establish just and reasonable rates, then state commissions could "make a determination not to take into account all or part of any such federally approved rate or charge in establishing a just and reasonable rate or charge by the associate company."

The state commission disallowance is now prohibited. As the Supreme Court found last month:[4]

> When FERC sets a rate between a seller of power and a wholesaler-as-buyer, a state may not exercise its undoubted jurisdiction over retail sales to prevent the wholesaler-as-seller from recovering the costs of paying the FERC-approved rate. Such a "trapping" of costs is prohibited.

S.1149 would authorize the "trapping" of wholesale power supply costs on holding company systems. The result would be that the local utility would not recover the full costs of purchased power that FERC determines to be just and reasonable. Ultimately, the utility system as a whole would underrecover the cost of providing service to its customers. The underrecoveries could continue throughout the 30 to 40-year life of a major generating facility. Over the long term, the disallowances could affect the utility's ability to provide adequate and reliable service.

This result is not necessary to assure fair rate treatment to customers. As part of its responsibilities under the Federal Power Act, FERC fully reviews the prudence of the selling utility's investments and the reasonableness of its expenses when setting the wholesale rate. For example, with respect to our System, FERC has recently conducted extensive investigations into NEP's nuclear investments and an outage at one of its major coal generating units. The records in those cases and NEP's other general rate filings are extensive. All affected states are represented. The rates that result from the investigations are just, reasonable, and fair to all parties.

D. S. 1149 Would Discourage Interstate Transactions Necessary for Low-Cost, Reliable Service to Customers

The disallowances and complex regulatory proceedings that would be spawned by the S.1149 would harm not only utilities, but also their customers. Although the bill applies only to affiliate transactions, it adversely affects the national interest in interstate, wholesale power transactions. Utilities are now tied together in a national transmission grid that allows transfers of power across state, regional, and even national boundaries. The planning and operation of electrical facilities now more than ever affect national interests and transcend the boundaries of individual states.

Holding company systems have played a major role in developing cooperative efforts that produce savings for all customers in the region regardless of state boundaries and franchise areas. For example, the generation of most holding company systems is "pooled" or dispatched centrally to maximize efficiencies on the integrated system regardless of state lines and affiliate franchise areas. In New England, this centralized dispatch or power pooling extends to all utilities in the region.

Because of this integrated operation and the limited sites available for new generation, utilities have also jointly participated in the development of new generating sources. For example, NEP has entitlements in generating units in all six New England states. The search for new sources of economic generation does not stop at the boundaries of New England. NEP and the other New England utilities have also agreed to import electricity from Quebec and other Canadian neighbors. This joint development of energy facilities in the region is based on the need to exploit cost-effective power sources wherever located and to allow the smaller utilities in New England access to benefits of larger projects which they could not individually undertake.

S. 1149 would discourage this interstate cooperation among utilities. Prior approval by all state commissions for nearly every generation project in New England would add additional proceedings and delay to the already complex permitting process at the outset of a project. Because many commissions lack the jurisdiction to grant the approvals, the bill creates the potential for significant disallowances after completion. The regulatory complexity and risk would discourage interstate wholesale transactions. The prospect of triggering major proceedings in several jurisdictions with inconsistent results and major disallowances would chill any utility's enthusiasm for a project regardless of its need and anticipated benefits to customers. As a result, the opportunities may not be pursued. The potential efficiencies associated with interstate transactions would not be fully realized, and customers would experience higher costs.

CONCLUSION

There is an independent Federal interest in interstate wholesale power supplies and a need for comprehensive, effective regulation of interstate utility holding company power transactions. The present system of state and Federal regulation meets that interest and provides that effective regulation. S. 1149 would not. It would undermine FERC's exclusive jurisdiction, invite conflicts among states, lead to unrecovered costs, and discourage the integrated system planning and interstate wholesale transactions necessary to provide low-cost, reliable service to customers.

Footnotes

[1] *See Public Util. Comm'n v. Attleboro Steam & Elec. Co.*, 273 U.S. 83 (1927).

[2] *New England Power v. New Hampshire*, 455 U.S. 331 (1982).

[3] *Nantahala Power & Light Co. v. Thornburg*, Docket No. 85-568, (S. Ct. June 17, 1986).

[4] *Nantahala Power & Light Co. v. Thornburg*, pp. 16-17, citations omitted.

Senator **Bumpers**. Thank you, Mr. Greenman.
George.

STATEMENT OF GEORGE E. WHITE, JR., VICE PRESIDENT, MIDDLE SOUTH SERVICES, INC.

Mr. **White**. Thank you, Senator, and Senator Pryor. My name is George White. I am vice president of Middle South. Originally, Mr. Regis Trumps, our vice president of system planning and forecasting, was to testify for the Middle South Utility System. Unfortunately, Mr. Trumps has had a death in the family and cannot be here. I ask that his testimony be included in the record.

Middle South opposes S. 1149. One year ago today, then MSU Chairman Floyd Lewis appeared before the Senate Energy Committee to discuss the history of Grand Gulf and our position on S. 1149. I will not repeat that testimony, but I would like to incorporate it by reference because today's hearing is simply a continuation of that testimony.

Grand Gulf was planned for our system by the operating companies in the early 1970's both to meet projected load growth and to diversify our fuel supply away from oil and gas. Statistics that focus only on Middle South's capacity margin overlook the fact that it was also built to diversify our fuel supply. We knew we were going to have more than a normal capacity margin, but we had so much original oil and gas capacity that we needed to build additional coal and nuclear capacity to diversify our fuel supplies. Thus, capacity margins were not the only consideration.

Both before and after last year's FERC decision allocating 36 percent of the cost of Middle South Energy's share of Grand Gulf Unit I to AP&L, there had been statements about the resulting dire economic consequences for Arkansas. Our economic statistics and projections do not bear this out.

The first year net increase in rates due to Grand Gulf I was less than 4.5 percent. By the sixth year, the cumulative net rate increase will peak at about 16 percent and will decline to a cumulative Grand Gulf net increase of approximately 12 percent by the eleventh year.

S. 1149, we believe, is unfair because it would impose severe penalties on us for failing to comply with requirements which did not exist and with which it would be impossible to comply. S. 1149 relates to FERC decisions after May 1, 1985, such as the June 13, 1985 allocation of Grand Gulf unit I, but the approvals it requires had to be obtained in 1973.

Had S. 1149 been in effect over the past couple of years, it is doubtful that Arkansas Power & Light Co., would now have two nuclear and four coal units to provide it with a diversified, low cost and stable generation mix. The other companies of the Middle South Utility system have helped Arkansas Power & Light Co. pay for the construction of its powerplants.

Since 1980, AP&L and its customers have benefited from capacity support payments of nearly $500 million paid by the other Middle South operating companies for these and other generating units which did not receive construction approval by the other companies' regulatory bodies. The other Middle South companies are currently paying AP&L more than $4 million each month in such capacity payments.

Our Founding Fathers thought it important that States not be allowed to impede interstate commerce. In the 1927 *Attleboro* decision, the U.S. Supreme Court ruled that States could not interfere with interstate commerce by reserving the cheapest generation in the State to that State's customers. The Federal Power Act set up a complex regulatory system that has filled this *Attleboro* gap for more than 50 years. There is no Grand Gulf gap in regulation.

As brought out in testimony earlier, the Federal Energy Regulatory Commission was asked to allocate the cost of the south Texas nuclear project among the subsidiaries in the holding company system, but the FERC ALJ refused because the factual situation in that particular case was much different than the factual situation in the *Grand Gulf* case.

The Federal Energy Regulatory Commission has sufficient authority to regulate these sorts of transactions, and if their decisions are arbitrary and capricious, the courts will reverse them. Those who are upset with a particular regulatory outcome wish to impose double jeopardy and conflicting regulation on us, which would not be right.

Thank you very much.

[The prepared statements of Mr. White and Mr. Trumps follow:]

ORAL STATEMENT OF
GEORGE E. WHITE, JR.
VICE PRESIDENT
MIDDLE SOUTH SERVICES, INC.
BEFORE THE
SUBCOMMITTEE ON WATER AND POWER
OF THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
OF THE
UNITED STATES SENATE
JULY 23, 1986

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to testify before you and explain the Middle South Utilities System's opposition to Senator Bumpers' proposed bill, S.1149. One year ago today, then MSU Chairman Floyd Lewis appeared before the Senate Energy Committee to discuss the history of Grand Gulf and our position on S.1149. I will not repeat that testimony but I would like to incorporate it by reference because today's hearing is simply a continuation of that testimony.

Middle South Utilities, Inc. (MSU) is a registered public utility holding company with four subsidiary electric companies operating in parts of Arkansas, Louisiana, Mississippi and Missouri. The generating and transmission facilities of the Middle South System have been planned and constructed on a coordinated basis and are operated on a fully integrated basis, as required by the Public Utility Holding Company Act. MSU also owns Middle South Energy, Inc. (MSE) which own 90% of the Grand Gulf Nuclear Station in Mississippi.

Grand Gulf was planned for our System by the operating companies in the early 1970's, both to meet projected load growth and to diversify our fuel supply away from oil and gas. None of our operating companies could finance the Grand Gulf project given other contemporaneous construction programs; thus, MSE was created to accomplish the task. The output of Grand Gulf was allocated among the operating companies and, due to the interstate nature of the arrangement, the Federal Energy Regulatory Commission (FERC) had jurisdiction and reviewed the allocation.

Before and after last year's FERC decision allocating 36% of the cost of MSE's share of Grand Gulf Unit 1 to Arkansas Power & Light Company, there have been statements about the resulting dire economic consequences for Arkansas. Our economic statistics and projections do not bear this out. The first year net increase in rates due to Grand Gulf Unit 1 was less than 4.5%. By the sixth year, the cumulative percentage net rate increase will peak at about 16% and will decline to a cumulative Grand Gulf net increase of approximately 12% by the eleventh year.

We have been accused of attempting to circumvent regulation with respect to Grand Gulf. Actually, we were seeking a way to finance a large-scale source of reliable, economical electrical energy for our customers. We did so openly and in compliance with all applicable regulatory requirements and then-existing federal and state laws. One thing which we certainly have not accomplished is a circumvention of regulation.

S.1149 is unfair because it would impose severe penalties on us for failing to comply with requirements which did not exist and which it would be impossible to comply with. S.1149 relates to FERC decisions after May 1, 1985, such as the June 13, 1985 allocation of Grand Gulf Unit 1 but the approvals it requires had to be obtained in 1973.

S.1149 would not only affect those rare set of circumstances such as Grand Gulf but it would also have a far-reaching adverse impact on power pooling throughout the country. Every power pooling agreement with which I am familiar includes some form of generating capacity sharing among its members and is subject to FERC approval. S.1149 would give each state PUC a veto over any holding company subsidiary participation in such a power pool.

Had S.1149 been in effect, it is doubtful that AP&L would now have two nuclear and four coal units to provide it with a diversified, low cost and stable generation mix. Since 1980, AP&L and it's customers have benefited from capacity support payments of nearly $500 million made by the other Middle South operating companies for these and other generating units which did not receive construction approval by the other companies' regulatory bodies. The other Middle South companies are currently paying AP&L more than $4 million each month in such capacity payments.

Our Founding Fathers thought it important that states not be allowed to impede interstate commerce. In the 1927 Attleboro decision, the U.S. Supreme Court ruled that states could not interfere with interstate commerce by reserving the cheapest generation in a state to that state's customers. The Federal Power Act set up a complex regulatory system that has filled the "Attleboro gap" for more than 50 years. There is no "Grand Gulf gap" in regulation. The Federal Energy Regulatory Commission has sufficient authority to regulate such transactions. Those who are upset with a particular regulatory outcome wish to impose double jeopardy and conflicting regulation. That would not be right.

STATEMENT
BY
REGIS G. TRUMPS
VICE-PRESIDENT, SYSTEM PLANNING AND FORECASTING
MIDDLE SOUTH SERVICES, INC.
BEFORE THE
SUBCOMMITTEE ON WATER AND POWER
OF THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
OF THE
UNITED STATES SENATE
JULY 23, 1986

I am Regis G. Trumps, Vice-President of System Planning and Forecasting for Middle South Services, Inc., which is a subsidiary of Middle South Utilities, Inc. I appreciate this opportunity to testify before the Subcommittee on Water and Power concerning Senator Bumpers' proposed bill, S.1149.

Senator Bumpers has introduced this legislation to provide the Arkansas Public Service Commission with authority to prevent the recovery in retail rates by Arkansas Power & Light Co. (AP&L) of the Federal Energy Regulatory Commission (FERC) approved, legitimate purchased power costs related to the Grand Gulf Nuclear Station.

S.1149 would amend the Federal Power Act to grant such state regulatory authority veto power if:

1. The purchases of electricity were between companies within the same public utility holding company system, and

2. The state commission had not first approved the construction of the generating unit upon which the costs are based.

Specifically, we oppose this legislation because it:

1. Is clearly aimed at Grand Gulf;
2. Encourages protectionism within the U.S.;
3. Adversely impacts power pooling;
4. Conflicts with policies underlying the Federal Power Act;
5. Is retroactive legislation; and
6. Addresses a non-existent peril;

CLEARLY AIMED AT GRAND GULF

Obviously, S.1149 was molded to fit the factual circumstances surrounding Grand Gulf and is an attempt to preclude Arkansas ratepayers from paying for Grand Gulf at the expense of others.

By way of background, Middle South Utilities, Inc. (MSU) is a holding company registered under the Public Utility Holding Company Act of 1935. MSU owns all of the outstanding common stock of four operating electric utility subsidiaries - AP&L with customers in Arkansas and Missouri, Louisiana Power & Light Co. (LP&L), Mississippi Power & Light Co. (MP&L) and New Orleans Public Service Inc. (NOPSI). MSU also owns all of the outstanding common stock of Middle South Energy, Inc. (MSE), a generating company formed in 1974 to construct, finance, own and operate certain future base load generating facilities, and of Middle South Services, Inc. (MSS), which provides professional and technical services at cost to the System companies.

Grand Gulf, located in Mississippi, was approved by the Mississippi Public Service Commission and the federal government through Securities and Exchange Commission (SEC) approvals of financing plans and of the formation of MSE, and by the Nuclear Regulatory Commission (NRC) and its predecessor, the Atomic Energy Commission (AEC), in the licensing process. With the exception of environmental permits, approval by other regulatory bodies was not then required nor did these bodies assume any authority to approve individual companies' participation in such an interstate project being constructed in another state.

Rather than reiterate the entire history of the Grand Gulf Nuclear Station, I refer you to the attached written statement of Floyd W. Lewis, then Chairman and President of Middle South Utilities, who testified before the Senate Committee on Energy and Natural Resources on July 23, 1985. Mr. Lewis' statement describes and explains the Middle South System's decisions regarding construction, financing and allocation of Grand Gulf Unit 1 and provides a history of the FERC Grand Gulf case.

The FERC issued its Opinion No. 234 on June 13, 1985, whereby the four operating companies of Middle South Utilities were allocated fixed percentages of Middle South Energy's 90 percent share of Grand Gulf Unit 1 costs (AP&L - 36%, MP&L - 33%, LP&L - 14% and NOPSI - 17%). Months later, each of the affected regulatory bodies recognized the FERC's authority to regulate wholesale electricity sales in interstate commerce and allowed Grand Gulf Unit 1 costs to be reflected in retail rates.

When Mr. Lewis testified a year ago today, the Middle South System's financial back was against the wall. Our very survival hinged on the hope that our operating companies would be able to obtain retail rate relief from their respective regulators in time to avert financial diasaster.

Finally, after MSU was forced to omit the dividend on its common stock, some relief was granted in some jurisdictions. Some regulators, seeing Middle South take that drastic step, moved toward a middle ground and negotiated settlements. Other regulators were prodded by the courts into issuing orders recognizing Grand Gulf costs in retail rates.

The drastic dividend action brought concessions in other quarters as well. Middle South Energy had borrowed a substantial amount of money to build Grand Gulf. MSE's creditors reluctantly agreed to several critical extensions to the loan agreements.

This regulatory ordeal began with our FERC filings in 1982 and is not yet over. FERC Opinion No. 234 has been challenged in federal court. The D.C. Circuit Court of Appeals heard oral arguments on March 24, 1986, on Mississippi Industries et al v. Federal Energy Regulatory Commission (case Nos. 85-1611, et al.) and a decision is forthcoming on the very issues which S.1149 addresses. The appellate court will decide whether or not the FERC acted properly, and it is likely that the U.S. Supreme Court will subsequently be asked to consider the issue.

We submit that S.1149 would impose such severe restrictions on public utility holding companies and related power pooling arrangements that the economic benefits and efficiencies such arrangements have yielded in the past would be disrupted to the detriment of ratepayers. S.1149 is aimed at one issue, Grand Gulf, but its impact reaches far beyond.

As we can attest, the cost of constructing economical, large-scale generating facilities can be out of the reach of all but the largest and the most financially stable utilities and requires creative financing approaches. As described in Mr. Lewis' statement, MSE was created for just such a purpose when it became obvious that neither MP&L nor any of its sister companies could finance the Grand Gulf project, given other contemporaneous construction programs. The output of Grand Gulf Unit 1 was intended to be allocated among the operating companies and, due to the interstate nature of the arrangement, FERC became the regulator. We were not attempting to circumvent state regulation nor were we trying to hide our approach. On the contrary, we were seeking a way to finance a large-scale project intended to provide a reliable source of economical electrical energy for the customers within the Middle South System. We did so openly and in compliance with all applicable regulatory requirements and then-existing state laws.

ENCOURAGES PROTECTIONISM WITHIN THE U.S.

As we see it, one of the serious flaws of S.1149 is that it would encourage state provincialism and could inhibit a public utility holding company system from constructing generating facilities to be used in interstate commerce for the overall benefit of several companies and their customers. Such provincialism was vividly displayed in proceedings before the FERC in the Grand Gulf and Middle South System Agreement cases where all regulatory bodies (and other intervenors) were strongly advocating that their respective jurisdictions' share be reduced and the shares of others increased. This approach to utility regulation - one of "let John pay for it" - will only lead to further efforts toward state isolation and insulation which is protectionism at its worst. Protectionism was the reason Congress recognized that state agencies were not an appropriate forum for regulation of interstate transactions and passed the Federal Power Act to "fill the gap". Moreover, such provincialism is directly contrary to current industry trends toward greater coordination of electric systems for the benefit of all. We contend that such an approach to the regulation of holding company utilities will eliminate or substantially delay joint projects in the future. Only with the unanimous consent of all the state regulatory bodies involved could a joint project be attempted, an extremely unlikely event as the record in the MSU System FERC cases has shown. This legislation runs counter to the long-standing congressional intent to preserve integrated public utility holding company systems and to encourage power pooling arrangements that can most economically and efficiently serve a geographical region.

ADVERSELY IMPACTS POWER POOLING

Because it has the potential for disastrous effects on affiliated company power pooling, S.1149 can only result in a detriment to long-term planning and in increased costs to customers. An essential ingredient of all power pooling agreements is a sharing of costs and benefits among the participants. This sharing includes, among other things, capacity and energy. It enables a pool to build more economical facilities than could a single member of the pool, requires less aggregate installed generating capability and uses the lowest cost energy sources to supply the loads of the companies through centralized economic dispatch. Inherent in these arrangements are payments by companies supplying less than their proportionate share of generating capacity to companies which are supplying more. These power pooling agreements are filed with, and approved by, the FERC following proceedings in which all interested parties have the right to participate.

Since these agreements almost always involve some form of reserve capacity sharing as described above, any state regulatory body could, under S.1149, undo FERC-approved pooling agreements by virtue of its new-found power to deny the recovery of capacity payments through retail rates. All affiliated-company power pooling agreements approved by the FERC after May 1, 1985, (such as the Middle South System Agreement which was approved June 13, 1985) would be exposed to such questionable treatment. With this exposure, it is more than likely that the main advantages of power pooling would simply disappear and costs to the customers would correspondingly increase as each company would be required to provide its own reserve generating capacity to continue to meet its legal obligation to serve all customers.

Had S.1149 been in effect, it is doubtful that AP&L would now have two nuclear and four coal units to provide it with a diversified, low cost and stable generation mix. Since 1980, AP&L and it's customers have benefited from capacity support payments of nearly $500 million made by the other Middle South operating companies for these and other generating units which did not receive construction approval by the other companies' regulatory bodies. The other Middle South companies are currently paying AP&L more than $4 million each month in such capacity payments.

CONFLICT WITH POLICIES UNDERLYING THE FEDERAL POWER ACT

Power pooling is a principal benefit to the customers of multi-state holding companies and is explicitly encouraged in the Federal Power Act. In 1978, the Congress reaffirmed the importance of wholesale sales through power pooling agreements. Section 205 of the Public Utilities Regulatory Policies Act of 1978 (PURPA) gives the FERC the authority to exempt electric utilities from any provision of state law, rule or regulation which prohibits or prevents the voluntary coordination of electric utilities as exemplified by the Middle South power pool.

RETROACTIVE LEGISLATION

S.1149 would impose severe retrospective penalties on holding company utilities that did not obtain prior certification from all their respective state regulatory bodies.

Arkansas did not require such approval at the time Grand Gulf Unit 1 was certificated and constructed, and the Arkansas Public Service Commission (APSC) assumed no authority to approve the construction of a plant in another state. S.1149 would, thus, not only impair AP&L's contractual obligations but would do so for failure to get approval when such approval was unnecessary and unavailable at the time. Indeed, a state law requiring APSC approval did not exist at the time S.1149 was introduced in Congress, and such a law did not even exist until June 28, 1985, only three days before Grand Gulf 1 was placed in commercial operation. It is obviously impossible now for AP&L to comply with the requirement retroactively. Such a harsh retrospective application is grossly unfair.

While S.1149 is really directed at Arkansas, it would apply to all holding company utilities in similar circumstances. Had a state law requiring prior approval been in existence, a holding company utility would have abided by it or challenged it in a timely manner prior to making major commitments. The potential consequences would have been too severe to do otherwise.

Given what we have been through over the last several years, I can flatly state that we will never again initiate such an interstate generating facility without seeking the irrevocable approval and support of all the appropriate regulatory bodies. That is not to say that we could be supportive of S.1149 even if it were only prospective in nature.

The impact this legislation would have on power pooling among affiliated companies would remain as an insurmountable barrier despite any efforts to cure its retroactivity.

ADDRESSES A NON-EXISTENT PERIL

Since the FERC decision allocating 36% of the cost of Grand Gulf Unit 1 to AP&L, much has been said and written about the dire economic consequences which Arkansas will allegedly bear. Some have predicted that no new industry will come to Arkansas and that industries currently located there will leave. This overemphasizes the importance of the cost of electricity to most industries and does a great disservice to Arkansas and the abundant resources it has to offer. Far more important factors - exchange rates, interest rates, the national business cycle, income growth, inflation, product prices and demands - influence the Arkansas economy, overshadowi the impacts of electricity price increases (or decreases).

Commercial establishments locate near demand centers - and electricity price levels are not a major consideration. Price increases typically affect electricity consumption; that is, price-induced conservation measures may be implemented or fuel substitution may occur. However, since commercial establishments - restaurants, grocery stores, office buildings, retail outlets - serve a very localized economy, their economic health is overridingly dependent on the health of local industries. If an area's industries are healthy, incomes will expand, population will grow, and business will be "good".

Similarly, regional residential growth patterns are affected by a wide variety of factors: taxes, the quality of educational systems, housing costs, the availability of shopping centers, cultural amenities, and most importantly, the availability of jobs. Electricity prices directly affect residential consumption but do not affect migration or settlement trends.

Logic dictates that, if industry is relatively insensitive to electricity price level, the commercial and residential sectors will not be significantly influenced by the cost of electricity in deciding where to locate.

Reynolds Metals Company, for many years AP&L's major industrial customer and a leading participant in the Settlement Agreement approved by the Arkansas Public Service Commission in September, 1985, has frequently been used as an example of the "devastation" Grand Gulf has brought to Arkansas. While it is true that Reynolds has closed down most of its operations in Arkansas, company officials cited softness in the worldwide demand for aluminum as a primary reason for this closure. In fact, AP&L recently attempted to get Reynolds to reopen its facilities by offering a bare-bones incentive rate. Reynolds was unable to take advantage of this offer due to its inability to obtain the necessary concessions from its labor union, as well as to a continuing, depressed aluminum market.

Most industries in the AP&L service area are relatively insensitive to electricity prices. The attached article, "The Significance of Electric Energy Costs to Industrial Firms in Arkansas", (Public Utilities Fortnightly, June 27, 1985), reports on a survey conducted by Phillip Taylor, Director of the Bureau of Business and Economic Research at the University of Arkansas and Mary S. Hirsch, a research analyst in that bureau. This survey indicated that, for the top ten percent of AP&L's industrial customers in each SIC manufacturing group as measured by 1983 sales, electricity accounted for an average of less than three percent of their costs of materials and supplies and less than five percent of total operating costs.

The assets of Arkansas, which are attractions for industry and which are so readily overlooked by the doomsdayers, include:

- the availability of labor
- a positive work ethic
- a central location/proximity to markets
- raw materials
- weather
- the environment

This survey concluded that:

> The data do not suggest a catastrophic impact on industry within the AP&L service area if the potential rate increases associated with events pending at the time of the study actually materialize.
>
> The relative significance of electric energy costs as a part of operating costs varies across industries as does operating margins and the elasticity of demand for an establishment's output. Moreover, the availability, or lack, of other resources (labor, timber, et cetera) may be of equal, or greater, importance than the cost of electric energy. The study results did indicate, however, that the uncertainty associated with rates was a negative location factor.

Since the September, 1985, Grand Gulf Settlement Agreement, that uncertainty has been largely eliminated. The first year net increase in rates relative to Grand Gulf Unit 1 was only 4.45% overall. In fact, by the sixth year, the cumulative percentage net rate increase will peak at approximately 16% and will decline to a cumulative Grand Gulf net increase of approximately 12% by the eleventh year.

The attached report, "Arkansas Economic Outlook" published in April, 1986, by the University of Arkansas at Little Rock, forecasts strong economic growth for Arkansas in 1986 and 1987. The report states that the unemployment rate in Arkansas averaged a full percentage point less in the first quarter of 1986 compared to 1985, and that manufacturing employment showed a seasonally adjusted annual growth rate of 11% for the fourth quarter of 1985 corresponding to a 3.5% decline nationally. Furthermore, the report forecasts a growth in personal income of 7.0% for 1986, well above the national average of 5.6%. This report labeled manufacturing "a bright spot in the State's economy" and had this to say:

> The loss of manufacturing jobs since 1979, both nationally and in Arkansas, is a well known fact. What hasn't been fully appreciated, though, is that Arkansas has done substantially better than the rest of the country in regaining those jobs....[B]oth Arkansas and the U.S. lost manufacturing jobs each year from 1979 through 1982 and the U.S. continued losing jobs through 1983. By the end of 1985, however, Arkansas had regained 97 percent of the manufacturing jobs it had in 1979 whereas the nation was only back to 92 percent. Even so, we are not forecasting a return to the previous peak level of manufacturing employment before 1988.
>
> A leading cause of Arkansas' performance in manufacturing output and employment is unit labor costs....[L]abor costs per dollar of output (unit labor costs) in Arkansas are substantially lower than the average for the U.S. This makes Arkansas a more attractive location for manufacturing plants. The force of these cost advantages is seen most dramatically in the food products and printing and publishing industries where employment growth has been extremely strong and the number of jobs now exceeds the 1979 level.

These reports and ongoing statements in political circles indicate that Grand Gulf has not caused Arkansas to become a "desert" on either the economic or the political front. In fact, this whole issue is more one of political rhetoric rather than economic reality.

CONCLUSION

In conclusion, I would urge this Congress not to dismantle a significant portion of the Federal Power Act by vesting ultimate authority over interstate projects and power pools in state regulators who will then be encouraged to disregard regional or national interests. The current regulatory framework is wisely conceived and well suited to judge the overall merits of power pools and interstate projects and to accommodate many competing interests. This well established framework should not be discarded or undermined, especially when there are serious questions as to workability and, indeed, the basic fairness of the proposed replacement, S.1149.

The Significance of Electric Energy Costs to Industrial Firms in Arkansas

By PHILLIP TAYLOR and MARY S. HIRSCH

This article reports findings of a research project undertaken by the authors to determine the significance of expenditures for electric energy for manufacturing and other industrial establishments in the state of Arkansas – their impact on competitive position and on potential expansions and relocations.

There are a great many factors that affect the location choices of private firms. These factors are, for the most part, those that will, or are expected to, impact upon the anticipated profitability of a location. That is, a rational firm will make location choices premised upon expected revenues, costs, and ultimately, long-term profitability.

The importance of the cost, and ready availability, of energy as a location factor was enhanced by the increased price of petroleum that followed the Arab oil embargo. The economic consequences of this incident varied between firms, industries, and geographic regions. The current cost of, and demand for, electric energy is one such consequence. As with other industries, increases in petroleum cost do not uniformly impact upon all electric energy producers and, consequently, upon all consumers of electric energy.

Scope and Design of Study

The purpose of our study was to investigate (1) the significance of electric energy costs among a selected group of firms with plant locations within the Arkansas Power and Light Company service area in Arkansas, (2) the relative importance of electric energy costs between industries in the portion of Arkansas served by AP&L as compared to other locations, (3) the attitudes toward, and expectations for the future of, the economic climate of Arkansas among the managers of selected Arkansas manufacturing facilities, and (4) the advantages and disadvantages of Arkansas as a location for manufacturing establishments.

Phillip Taylor is director of the Bureau of Business and Economic Research and professor of data processing and quantitative analysis at the University of Arkansas. He has been chairman of the Arkansas Governor's Council of Economic Advisors since its inception, and has served on the board of directors for both the Association for University Business and Economic Research and the Travel Research Association. **Dr. Taylor** received a BA degree from Lamar University and an MBA and a PhD degree in business administration from the University of Arkansas.

Two questionnaires were used to gather current data for the study. One was created to elicit information concerning plants located in AP&L's service area and the other was designed to obtain similar data from plants of the same firms but located elsewhere. Both questionnaires requested information for the most recent fiscal year concerning employment, payroll, value of shipments, et cetera (in a form similar to that contained in *Annual Survey of Manufacturers*); data on various forms of energy purchased; and the level of production, outlook for the facility, opinions concerning Arkansas as a plant location, et cetera. The questionnaire distributed to establishments outside the AP&L service area omitted the questions concerning production, outlook, and Arkansas as a plant location.

The plants selected to receive the questionnaire were approximately the top 10 per cent of AP&L's industrial customers in each standard industrial classification (SIC) manufacturing group, or a total of 181 plants. The top 10 per cent was measured in terms of dollar sales in 1983.

A person at each plant was identified as the contact person for the study, and prior to the delivery of the questionnaire the director of the Arkansas Industrial Development Commission wrote each to tell them about the project and request their cooperation. The questionnaires were hand-delivered to the specified contact person at each plant by AP&L customer service representatives in late June and early July, 1984. The packages delivered to each plant included a letter from the principal investigatory, a copy of the questionnaire for that plant (with a sheet defining terms), three copies of the questionnaire for plants outside the AP&L service area, and envelopes for returning the completed questionnaires to the university. Subsequently, two follow-up letters were sent encouraging participation in the study.

It is important to note that the survey material covered what many participants considered very confidential and sensitive information. This fact impacted the level of participation in that several firms responded that company policy prohibited disclosure of the data.

Analysis of the Significance of Electric Energy Costs

Of the 181 questionnaires distributed, 100[1] were returned in various stages of completion. Thus, the number of observations varies according to the availability of answers.[2] Because of the need to protect confidentiality, it was necessary to omit some groups when reporting the data classified by SIC. That, along with the fact that no usable responses were received from SIC 23 (apparel and other textile products) and SIC 38 (instruments and related goods) reduced the number of SIC specific categories that could be reported.

Based on the questionnaires of 76 respondents that provided answers to all relevant questions, the average cost of purchased electrical energy was $.0448 per kilowatt-hour. The respondents purchased 44,757 kilowatt-hours per employee, at an average cost of $2,007. Their EEP/VS ratio[3] was .0185 and electric energy purchased equaled 2.84 per cent of their cost of materials and services. The responding firms had a total employment of 27,752, or 365 employees per firm. These firms accounted for approximately 20 per cent of the employment and 39 per cent of the electric energy usage (kilowatt-hours and dollars) in the AP&L service area.

Using the maximum number of responses for each variable, the reported values change, but only modestly. The average cost of purchased electric energy becomes $.0444 per kilowatt-hour [91]. The respondents purchased 48,097 kilowatt-hours [85] per employee, at an average cost of $2,256 [92]. Their EEP/VS ratio was .0199 [85] and electric energy purchased equaled 2.9 per cent [83] of their cost of materials and services.

Based on all firms supplying the relevant data, the mean electricity expenditures as a per cent of total operating costs was 4.58 [83] and the mean for total operating costs as a per cent of sales was 84.70 [75]. Alternatively, the means of the SIC groups were 4.63 for electricity as a per cent of total operating costs and 82.27 for total operating costs as a per cent of sales.

The responding firms had a total employment of 33,364, or 363 employees per firm [93]. This amounted to 24 per cent of the employment in the AP&L service area. The 91 firms supplying energy data used approximately 51 per cent of the kilowatt-hours and produced 50 per cent of the revenues from the combined industries.

Summary

According to the survey respondents, the quantity of the labor, along with the prevailing work ethic, was the most noteworthy of Arkansas' industrial location advantages. This was tempered, somewhat, by the lack of skilled (technical) employees and what was perceived as inadequate vocational-technical training facilities.

The central location of Arkansas, or its proximity to markets, was a frequently mentioned advantage but, the absence of adequate transportation (rail, air, and in some instances, highway) reduced this advantage. Similarly, an Arkansas location was viewed as a disadvantage with respect to maintenance, customers, et cetera.

Raw materials, weather, and the environment were also considered to be advantages but while SIC's 20 and 24 viewed raw materials positively, the supply was seen as dwindling among the firms in some sectors.

Historical and current data indicate that electric energy cost for manufacturing establishments in Arkansas, and the AP&L service area, are at or below the national average. There was, however, concern expressed by the respondents about both the future cost of energy and the uncertainty created by a current Grand Gulf nuclear plant and Middle South Utilities system average costing controversy.[4] The uncertainty of the issue was cited frequently as a concern rather than the actual level of costs.

Electric energy cost, as well as that of some other utilities, was viewed as a negative factor among a large proportion of the establishments. However, comments would seem to indicate that cost *increases* and *uncertainty* were of almost equal significance to the actual *level* of costs. Some firms did view electric energy costs and availability as an advantage of an Arkansas location.

Government in Arkansas, both local and state, was neither clearly an advantage nor a disadvantage. This was inclusive of regulations and taxes.

With respect to long-term outlook (1985-90), ap-

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[1] One questionnaire contained information on more than one establishment but it was treated as a single response.

[2] The number of respondents upon which the data are based is given in brackets [ ].

[3] EEP/VS is electric energy purchased divided by value of shipments.

[4] Two cases involving AP&L are currently pending before the Federal Energy Regulatory Commission. One (Docket No. ER82-483-000) involves the allocation of production costs between the various companies in the Middle South System and the other (Docket No. ER82-616-000) specifically addresses AP&L's commitments relating to the Grand Gulf nuclear facility. In both instances, the Arkansas Public Service Commission has objected to agreements negotiated by AP&L. Inferences have been made that potential rate increases arising from increases in operating costs originating with Middle South and Grand Gulf will have disastrous impacts on industrial firms within AP&L's service area.

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proximately 42 per cent of the establishments expected expansion and 39 per cent expected a continuation of current levels of production. Over 12 per cent, however, expected cutbacks at their facility.

When asked if their company should decide to expand its capacity, whether that expansion is likely to be in Arkansas, over two-thirds (68.6 per cent) of the respondents said yes. Of that group, over 83 per cent believed expansion would be in the form of an increased investment at the responding establishment.

Conclusions

The data do not suggest a catastrophic impact on industry within the AP&L service area if the potential rate increases associated with events pending at the time of the study actually materialize.

The relative significance of electric energy costs as a part of operating costs varies across industries as does operating margins and the elasticity of demand for an establishment's output. Moreover, the availability, or lack, of other resources (labor, timber, et cetera) may be of equal, or greater, importance than the cost of electric energy. The study results did indicate, however, that the uncertainty associated with rates was a negative location factor.

AUTHORS' NOTE: The research project described in this article was done in cooperation with the Arkansas Industrial Development Commission and supported through a grant from Arkansas Power and Light Company. However, neither of those parties had access to the data gathered in the research effort, nor to the detailed analyses, beyond that included in a report essentially similar to this article. The conclusions reached are those of the authors and not necessarily those of the Arkansas Industrial Development Commission, Arkansas Power and Light Company, or the University of Arkansas, Fayetteville.

Table 1

Summary of Industry Averages

	SIC 20		SIC 24		SIC 26		SIC 28		SIC 29		SIC 30	
	N	Amount	N	Amount	N	Amount	N	Amount	N	Amount	N	Amount
Electric Energy Purchased/Value of Shipments (EEP/VS)	11	0 0137	16	0 0350	6	0 0350	5	0 0340		D	5	0 0'67
Electric Energy Purchased/ Employment	14	$1 319	16	$2 523	6	$5 273	5	$8 874	4	$10 170	5	$2 144
Kilowatt-hours/ Employment	13	27 222	13	53 717	6	128 124	4	232 991		D	5	47 577
Electric Energy Purchased/Cost of Materials and Services	12	0 0192	16	0 0541	5	0 0613	5	0 0602		D	5	0 0234
Cost Per Kilowatt-hour	14	$0 0483	13	$0 0505	6	$0 0412	4	$0 0374		D	6	$0 0441

NOTE: N indicates the number of establishments providing information.
D indicates a limitation on the ability to report in order to protect confidentiality.
These data are computed as the total for the number of firms shown divided by the number. Large firms could bias the results.

Table 1 (Continued)

	SIC 33		SIC 34		SIC 35		SIC 36		SIC 37	
	N	Amount	N	Amount	N	Amount	N	Amount	N	Amount
Electric Energy Purchased/Value of Shipments (EEP/VS)	6	0 0200	6	0 0213	4	0 0122	5	0 0062		D
Electric Energy Purchased/ Employment	6	$2 512	7	$1 468	4	$856	5	$729	4	$764
Kilowatt-hour Employment	6	49 502	7	28 306	4	17 333	5	14 939		D
Electric Energy Purchased/Cost of Materials and Services	6	0 0258	6	0 0405	4	0 0264	5	0 0074		D
Cost Per Kilowatt-hour	7	$0 0505	8	$0 0504	5	$0 0500	6	$0 0488		D

NOTE: N indicates the number of establishments providing information.
D indicates a limitation on the ability to report in order to protect confidentiality.
These data are computed as the total for the number of firms shown divided by the number. Large firms could bias the results.

Table 2

Summary of Firm Averages by Industry

SIC	Electricity Purchased as a Per Cent of Total Operating Costs N	Mean	CV	Total Operating Costs as a Per Cent of Sales N	Mean	CV	Employment N	Sum	Mean	CV
20	12	4.39	111.8	10	81.7	36.0	12	8,201	683	167.9
24	15	6.04	106.2	14	86.5	11.0	15	3,457	230	128.8
26	6	3.70	98.9	5	92.8	7.5	6	3,108	518	107.6
28	5	4.20	31.8	4	87.6	7.0	5	1,510	302	61.0
29	4	6.66	60.1		D		4	643	161	74.6
30	5	2.40	16.4	5	94.0	2.9	5	1,319	264	51.5
33	6	3.10	79.6	6	97.7	5.9	6	1,799	300	66.4
34	4	3.15	80.0	4	86.0	21.3	4	1,200	300	58.8
35	4	2.27	65.8		D		4	1,019	225	32.1
36	5	1.24	60.5	4	91.3	11.4	5	3,830	766	86.0

Note: N indicates the number of establishments providing this information.
D indicates a limitation on the ability to report in order to protect confidentiality.
These data were computed as an arithmetic mean of the firms. The data for each firm are given equal weight.

How Close Did We Come?

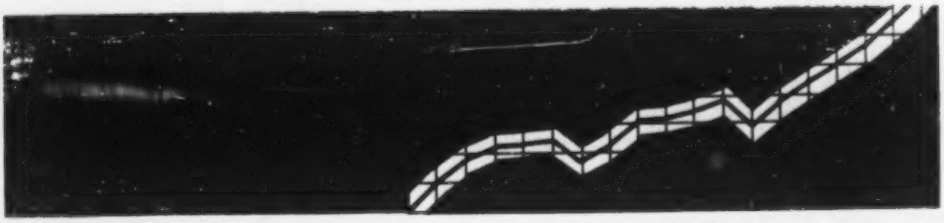
There has been considerable debate in Indiana concerning how much generating capacity is needed to meet the demands of homes and businesses for electricity. Currently a case is pending before the public service commission questioning whether there is "excess capacity" in the Northern Indiana Public Service Company service territory. Last winter's bitterly cold weather is now behind us and adequate energy was available to keep us warm. But how close did we come to using all of Indiana's electric generating capacity?

The Hoosiers for Economic Development Committee's research director, David Lantz, has reported that on January 21, 1985, the five investor-owned utilities in the state (Public Service Company of Indiana, Indiana and Michigan Electric Company, Northern Indiana Public Service, Southern Indiana Gas and Electric Company, and Indianapolis Power and Light Company) along with Hoosier Energy Rural Electric Cooperative had a combined peak demand of 11,936 megawatts. At the same time, these six utilities had a combined total capacity — on paper — of 16,853 megawatts. However, because of capacity unavailability due to scheduled and emergency maintenance, frozen coal piles, et cetera, these six utilities had a combined *available operating capacity* of just 12,132 megawatts. This left an actual reserve margin of 196 megawatts, *or just 1.6 per cent.*

In addition to the six major Indiana utilities, if one also includes the peak demand served by the many rural electric cooperatives and municipal utilities, Indiana's total peak demand on January 21, 1985, was 12,335 megawatts. This compares to a total state available operating capacity of just 12,382 megawatts, a difference of 47 megawatts (.4 per cent).

Lantz said, "Because HEDC's peak demand forecast for this winter ranged from 12,287 megawatts to 12,512 megawatts, our concerns about future capacity shortages at the turn of the decade continue to be confirmed. Because of the state of Indiana's efforts to attract the GM Saturn plant (which would require 80 megawatts of power 365 days a year), as well as other such projects, the need for an adequate supply of electricity is clear. Without an assurance of electric power availability, we will never know how many prospective employers will look at Indiana and say 'no.'"

The above is a statement released on May 30, 1985, by the Hoosiers for Economic Development Committee in Indianapolis.



VOL. I, NO. 2 — April 1986

Oil Price Drop: The Good and the Bad

The national economic outlook has not changed very much from that presented in the January forecast. Changes to the forecast come primarily in the first quarter of 1986 and reflect more up-to-date information on the state of the economy rather than a significant change in Wharton Econometric's outlook over the next three years.

The sharp decline in petroleum prices, with its devastating impact in the oil patch states, is causing some immediate weakness in economic conditions. Much of the current employment and retail sales weaknesses, for example, can be attributed to curtailment of oil drilling activities and lower nominal energy outlays. At the same time, deflation in the consumer price index is masking strength in nominal income growth and consumer spending.

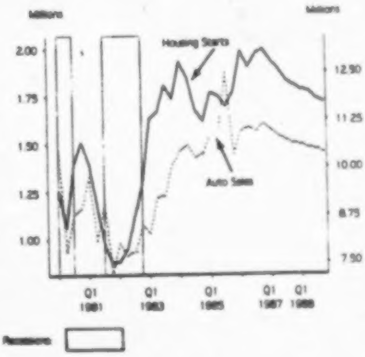
In fact, while the damage from lower oil prices is now being felt in full force, the benefits in terms of lower interest rates and stronger demand for consumer and capital goods are just beginning to appear. They should be clearly apparent by summer, however, and should set the stage for 4.5 percent growth over the second half of this year and 4.0 percent growth next year, making this the second longest recovery in the post-war period.

The lower interest rates forecast for 1986 should bring about very strong activity in both housing and autos. The lowest mortgage rates in a decade will bring housing starts up to almost the 2-million-unit rate and sales will grow commensurately. Auto sales will approach 11 million for the year. As interest rates rise with increasing inflation in 1987 and 1988, the activity in both these sectors will fall—though not too sharply. (See Figure 1.)

Thus, our forecast for 1986 is still for another year of rather mediocre performance in GNP growth—we now expect real GNP to increase 2.9 percent, up marginally from the 2.8 percent in January.

Figure 1

Housing Starts and Auto Sales



Gross National Product

Real GNP rebounded in the first quarter to a 3.2 percent rate of growth, up substantially from 0.7 percent in the fourth quarter of 1985.

The most stunning feature of this turnaround was net exports, which contributed $14.8 billion to real GNP—a sharp contrast to the fourth quarter's $21 billion decrease. Thus, last year's decline in the dollar is finally having its effect on GNP; domestic exporters are now enjoying their exchange rate advantage in foreign markets.

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UALR REA

Personal consumption expenditures were up $28.4 billion, a 4.3 percent annual rate of increase. Much of this increase was in nondurables, which include gasoline and heating oil. Business fixed investment plummeted $17.4 billion from cuts in purchases of information-processing equipment and energy-related structures.

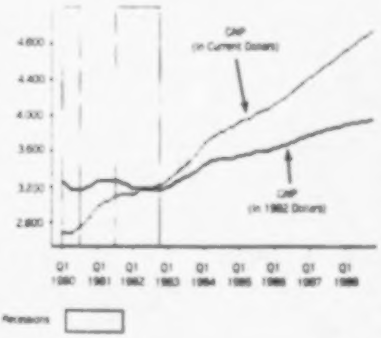
Inventory investment increased $26.0 billion, mainly because of a massive reduction in government food purchases. Lower nondefense government purchases reflect this income-account trade-off.

The first effects of declining oil prices can be seen in these Bureau of Economic Analysis data—other beneficial effects are soon to come. The GNP deflator rose only 2.2 percent last quarter, down from 3.9 percent in the previous quarter—the lowest rate of growth since the mid-1960s. The performance of the CPI was even more dramatic; for the first three months of the year consumer prices actually fell at an annual rate of 1.9 percent, the best performance since 1954.

Continuing declines in long- and short-term interest rates due to this low rate of inflation should eventually encourage improved levels of investment for the remainder of this year. Fueled by better foreign trade conditions and strong levels of consumption, GNP should continue to grow over the forecast period. (See Figure 2.)

Figure 2

Gross National Product



Industrial Output

The Federal Reserve Board's index of industrial production fell 0.5 percent in March, its second consecutive decline. The index was pulled down by weakness in oil and gas drilling activity and in auto assemblies.

Output of consumer goods fell 0.7 percent in March, as durables dropped 2.9 percent with plunging auto production; nondurables rose 0.1 percent. Output of business equipment fell 0.9 percent, and defense and space equipment rose 0.6 percent.

On an industry basis, manufacturing output fell 0.5 percent, with durables down 1.0 percent and nondurables up 0.4 percent. Mining output fell 1.1 percent to 6.8 percent below its year-earlier level. Utilities output edged down 0.1 percent.

This release shows that the very near-term effects of lower oil prices can be depressing despite the positive influence they should exert on the economy a quarter or two down the road. It also highlights the differences between sectors—the U.S. energy industries will have a very tough time dealing with lower returns on their exploration and other investments.

However, the energy industries alone will not pull down overall industrial production this year. The fundamentals for a strong 1986 are definitely there—low inflation and interest rates to stimulate consumer demand, a weakened dollar to bring more of that demand to domestic producers, and lean inventories combined with still moderate capacity utilization rates to allow producers to benefit from the heightened demand.

Employment

The Bureau of Labor Statistics reported that the unemployment rate edged down to 7.2 percent from 7.3 percent in March, after jumping 0.6 of a percentage point in February. Weakness was concentrated in the goods-producing sectors, particularly the oil and gas industries.

The household employment survey showed the number of jobs virtually unchanged. Agricultural employment did reverse its large weather-related drop from February, however.

The more reliable survey of nonagricultural business establishments registered a gain of 190,000 in jobs. However, manufacturing jobs edged down 40,000 and mining employment fell 30,000, its lowest level since 1978, while employment in services continued to grow.

Average weekly hours edged up 0.1 hour, and the manufacturing work week and factory overtime rose by similar amounts.

This release shows us that we may have underestimated the effects of oil and gas industry declines on overall employment growth in the very short-term. However, as outlined previously, the fundamentals for economic health are still there. We feel that it's only a matter of a few months until output and job growth confirm these positive indicators. Employment gains should return to both the household and establishment surveys and the unemployment rate should decline through this year and next.

Personal Income

Personal income rose $5.9 billion (SAAR) in March following February's revised increase of $14.1 billion. Disposable income rose $7.4 billion, while the saving rate fell marginally to 4.2 percent.

Wages and salaries posted a $9.6 billion advance in March. Exactly half of the increase was in service-related industries which gained $4.8 billion. Manufacturing wages reversed course, picking up a moderate $1.9 billion. Government payrolls increased $1.8 billion and distributive industries gained $2.2 billion. Farm income slid $7.5 billion compared with February's subsidy-induced increase of $3.4 billion.

Wharton Econometrics forecasts nominal personal income to grow at annual rates of 5.6 percent and 7.1 percent in 1986 and 1987, respectively. During the period, consumption growth will average 2.7 percent and 2.8 percent.

Changes in income and other selected measures of economic activity in the U.S. for 1985 and projected changes for 1986 and 1987 are given in Table 1.

Table 1

Selected National Economic Indicators

	1985	1986	1987
Economic Activity and Income (Percent Change)			
Gross National Product (GNP)	5.7	5.9	7.4
Real GNP (1982 $)	2.2	2.9	4.2
Consumption Expenditures	3.3	2.7	3.4
Business Fixed Investment	9.7	6.1	5.2
Residential Fixed Investment	1.7	10.1	3.6
Government Purchases	6.0	6.4	2.5
Changes in Business Inventories	1.8	[illegible]	4.0
Personal Income	5.8	5.6	7.1
Real Personal Income (1982 $)	2.6	2.9	3.3
Inflation and Determinants (Percent Change)			
GNP Deflator	3.3	2.9	3.2
CPI All-Urban	3.5	1.0	2.2
Compensation Per Hour	3.7	3.6	4.1
Output Per Hour	0.0	1.1	3.1
Unit Labor Cost	3.7	2.6	1.0
Financial Markets			
Money Supply (M1) Bil. $	620.2	671.4	716.4
Percent Change	11.9	8.3	6.7
Federal Funds Rate, %	8.10	7.03	7.35
3-Month T-Bill Rate, %	7.48	6.37	6.73
Bank Prime Rate, %	9.93	8.35	8.77
Moody AAA Bonds, %	11.37	8.94	9.28
Mortgage Rate: Existing Homes, %	11.74	10.10	9.84

Uneven Growth in Arkansas

Even as the performance of the U.S. economy in 1985 is being marked down by government statisticians, estimates of the performance of the Arkansas economy are being raised. Nonagricultural wage and salary employment increased 1.9 percent and preliminary estimates show that personal income rose 6.1 percent.

We continue to forecast strong economic growth for the state over the next two years, but the pattern of growth has become very uneven in recent months. Like the national economy, there is some weakness in the outlook for the first half of 1986, but employment and income growth will be stronger later in the year as the effect of a rising national economy impacts upon the state and stimulates industrial production.

The unevenness in the current business situation is illustrated by the mixture of recent good news and bad news.

The good news:

- The F.W. Dodge Report shows that the value of construction contracts in the first quarter is 19 percent above a year ago.
- Housing construction is up 14 percent in value and 30 percent by number of units compared to the first quarter of 1985.
- Nonagricultural wage and salary employment is up 4.5 in the first quarter from the same period last year.

- Payroll tax revenue for the first quarter of 1986 is up 12 percent from last year.
- The unemployment rate averaged a full percentage point lower in the first quarter of 1986 compared to 1985.

The bad news:

- Employment in durables manufacturing is essentially unchanged from the first quarter of 1985.
- Mining employment is down 11 percent for the quarter compared to the first quarter last year.
- Manufacturing output declined in 1985.
- Sales tax revenue for the first quarter of 1986 is up only 4.2 percent (1.0 percent in real terms) from the first quarter of 1985.

The picture which emerges is that some industries—construction and services primarily—are doing quite well while other industries—mining and farming—are doing poorly. However, the good news far outweighs the bad news, lending support to our forecast of strong economic growth for Arkansas in 1986 and 1987.

Employment

After growing 11 percent in the fourth quarter of 1985 (SAAR), manufacturing employment will probably decline slightly over the first six months of 1986. The strong employment growth in the fourth quarter masked some weaknesses—average weekly hours declined and factory overtime fell. Manufacturers are reluctant to lay off very many workers now, however, as they see a strong gain in orders in just a few short months, so a reduction in hours worked is their response to poor demand.

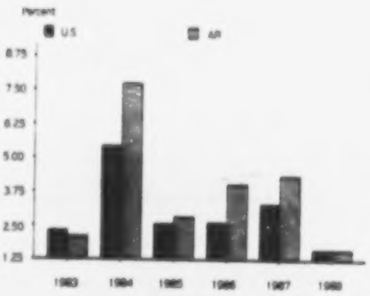
Personal Income

It now appears that income will grow slightly less than was forecast in January. Lower inflation and the removal of COLA payments on federal retirees' pay will reduce the rate of growth of transfer payments and an improved economy will reduce unemployment benefits. Also, lower interest rates have reduced our forecast of investment income.

Nevertheless, personal income is expected to grow more than 7.0 percent this year, well above the national average as is typical for Arkansas during expansions. (See Figure 3.) Two groups will fare better than we had thought earlier: farmers and other proprietors. As the implications of last December's five-year plan for agriculture become clearer, it is apparent that farm income will probably be slightly above last year's level. This is due more to generous government payments than to economic factors. Nonfarm proprietors should do very well as the profit outlook over the forecast period appears quite lucrative.

Figure 3

Real Income Growth, Arkansas and the U.S.



AGRICULTURE:
Rising Income, Declining Employment

The forecast for agricultural income is for a slight improvement over last year—a relatively good year for farm income. This somewhat optimistic outlook belies many problems which continue to persist in this industry, however.

Farm employment is declining in Arkansas as in the nation. New employment estimates from the Arkansas Employment Security Division show there are about 20,000 fewer jobs in agriculture than previously reported. Furthermore, our estimates of gross farm product in real dollars show that output remains below the 1981 peak. Since the livestock sector continued to expand, this decline in production is all attributable to the crop sector. The implications of these declines for suppliers to the crop sector (equipment, dealers, fertilizer and seed dealers, etc.) are obvious.

Furthermore, the gain in farm income is not due to market forces but in spite of them. It is primarily generous income support payments that lead to our forecast of a gain in farm

SELECTED ARKANSAS ECONOMIC INDICATORS - APRIL 1986
Rates of change are compounded annual rates (Not Seasonally Adjusted)

LABOR FORCE	1985 Q4	1986 Q1	Q2	Q3	Q4	1987 Q1	Q2	1985	1986	1987
Civilian Labor Force	1083.8	1059.9	1088.3	1091.8	1085.9	1075.0	1101.6	1051.7	1081.5	1093
% Change	-1.6	-8.5	11.1	1.3	-2.1	-3.9	10.2	.7	2.8	
Unemployment	88.7	96.4	82.1	72.6	73.0	81.1	65.8	88.4	81.0	65
% Change	-15.6	39.2	-47.4	-38.8	2.1	52.7	-56.8	-4.9	-8.4	-19
Unemployment Rate	8.2	9.1	7.5	6.7	6.7	7.5	6.0	8.4	7.5	6
Employment	995.0	963.6	1006.2	1019.2	1012.9	993.9	1035.8	963.3	1000.4	1028
% Change	-.2	-12.1	18.9	5.3	-2.4	-7.3	18.0	1.3	3.9	2.8
EMPLOYMENT BY INDUSTRY BY PLACE OF WORK										
Agriculture	56.1	34.1	58.9	54.7	42.1	33.8	58.1	60.6	45.5	44.7
% Change	-65.0	-86.4	396.4	33.4	-64.9	-58.4	394.3	-1.6	-25.0	-1.5
Nonagricultural Wage and Salary	812.7	803.5	822.3	828.0	836.9	828.2	847.5	797.2	822.7	848
% Change	7.8	-4.6	9.6	2.8	4.4	-4.1	9.6	1.9	3.2	2.5
Private Nonagricultural	662.1	651.8	672.1	684.1	681.2	672.3	693.3	652.0	672.3	692.6
% Change	1.4	-6.1	13.0	7.3	-1.6	-5.1	13.1	1.7	3.0	3.0
Manufacturing	215.1	211.4	215.7	217.7	216.0	213.0	217.6	211.7	215.2	216.8
% Change	6.2	-6.6	8.3	3.8	-3.1	-5.4	8.9	-.8	1.6	.7
Nondurable Goods Manufacturing	98.0	96.7	99.7	101.5	100.9	99.2	102.0	97.3	99.7	101.9
% Change	.7	-5.2	13.0	7.6	-2.3	-6.6	11.6	-1.4	2.4	[illegible]
Durable Goods Manufacturing	117.1	114.7	116.0	116.2	115.1	113.8	115.8	114.4	115.5	114.9
% Change	11.1	-7.7	4.4	.7	-3.8	-4.3	6.6	-.3	1.0	-.5
Mining	5.4	5.2	5.4	5.5	5.4	5.2	5.4	5.5	5.4	5.4
% Change	-8.3	-12.6	15.1	6.7	-6.6	-12.9	14.9	-.8	-1.0	-.6
Construction	36.5	32.2	37.2	40.6	38.3	34.7	40.0	36.3	37.1	39
% Change	-22.2	-39.2	78.5	41.2	-20.5	-32.5	76.0	5.0	2.2	5
Transportation and Public Utilities	47.3	46.1	47.0	47.7	48.2	47.0	47.8	46.2	47.3	48
% Change	4.7	-9.8	7.3	6.6	4.4	-9.9	7.1	2.0	2.2	1
Wholesale and Retail Trade	181.7	178.3	182.5	184.6	185.7	182	187.3	178.7	182.8	[illegible]
% Change	1.6	-7.3	9.8	4.0	2.3	-6.4	10.5	3.0	2.3	[illegible]
Wholesale Trade	42.3	42.0	42.7	43.1	42.9	42.6	43.6	42.1	42.7	43.5
% Change	-3.3	-2.3	6.8	3.5	-1.8	-1.0	7.8	2.4	1.4	[illegible]
Retail Trade	139.4	136.3	139.8	141.5	142.8	139.9	143.7	136.6	140.1	144
% Change	3.2	-8.8	10.7	5.2	3.6	-8.0	11.3	3.2	2.6	2.5
Finance, Insurance, and Real Estate	38.2	38.5	40.1	41.1	40.8	41.0	42.6	37.7	40.2	42.5
% Change	-.4	3.3	17.6	10.3	-3.5	1.8	16.6	5.1	6.6	5.9
Services	137.9	140.0	144.2	146.8	146.8	148.7	152.6	136.0	144.4	152.8
% Change	.8	6.3	12.5	7.4	.2	5.3	10.9	2.0	5.6	5.8
Civilian Government	150.6	151.8	150.2	144.0	155.7	155.9	154.2	144.4	150.4	153.5
% Change	43.3	3.1	-4.0	-15.6	36.7	.7	-4.4	2.8	4.2	2
Civilian Federal Government	21.3	20.9	21.5	21.6	21.2	21.0	21.6	21.0	21.3	21.4
% Change	-2.6	-6.8	11.9	2.3	-6.6	-5.1	13.3	1.8	1.3	.7
State and Local Government	129.3	130.9	128.7	122.4	134.4	135.0	132.6	123.3	129.1	132
% Change	53.3	4.8	-6.4	-18.3	45.7	1.6	-6.9	3.0	4.7	2.5
Dom Serv, Self-Empl & Unpd Fmly Wrkrs	131.5	131.9	138.6	143.6	141.5	140.1	146.7	128.9	139.1	145.9
% Change	2.6	1.1	25.6	11.8	-5.6	-3.6	20.1	-.7	7.9	4.6
HOURS AND EARNINGS										
Average Hourly Earnings Manufacturing	7.73	7.85	7.97	8.08	8.19	8.30	8.41	7.57	8.03	8.46
% Change	7.5	6.6	6.2	5.8	5.5	5.4	5.3	2.7	6.0	5.5
Nondurable Goods	7.87	7.98	8.07	8.17	8.27	8.36	8.46	7.71	8.12	8.51
% Change	5.7	5.3	5.0	4.8	4.8	4.8	4.8	6.0	5.3	4.8
Durable Goods	7.56	7.72	7.85	7.97	8.09	8.19	8.30	7.41	7.91	8.35
% Change	10.9	8.7	7.2	6.3	5.7	5.4	5.5	1.1	6.7	5.6
Average Weekly Earnings Manufacturing	308.46	315.94	315.15	319.55	328.56	339.46	337.92	303.42	319.80	341.79
% Change	6.0	10.1	-1.0	5.7	11.8	13.9	-1.8	1.8	5.4	6.9
Nondurable Goods	315.97	317.69	328.62	333.01	342.42	340.89	349.27	312.92	330.44	351.17
% Change	-.2	2.2	14.5	6.5	10.7	-1.8	10.2	2.1	5.7	6.2
Durable Goods	288.86	310.06	306.94	308.42	314.98	325.16	322.00	289.30	310.10	325.01
% Change	-1.2	32.7	-4.0	1.9	8.6	13.6	-3.8	.4	7.2	4.8
Average Weekly Hours Manufacturing	39.93	40.23	39.53	39.53	40.10	40.89	40.18	40.06	39.85	40.38
% Change	-1.4	3.1	-6.8	-.1	5.9	8.1	-6.7	-.8	-.5	1.3
Nondurable Goods	40.13	39.83	40.79	40.80	41.42	40.78	41.27	40.58	40.70	41.24
% Change	-5.5	-2.9	9.8	1.0	5.7	-6.3	5.1	-1.0	.3	1.3
Durable Goods	38.21	40.17	39.08	38.67	38.95	39.68	38.79	39.05	39.22	38.91
% Change	-10.9	22.1	-10.4	-4.1	2.9	7.7	-8.7	-.6	.4	-.9

SELECTED ARKANSAS ECONOMIC INDICATORS - APRIL 1988
Rates of change are compounded annual rates (Seasonally Adjusted)

PERSONAL INCOME BY SOURCE	1985 Q4	1986 Q1	Q2	Q3	Q4	1987 Q1	Q2	1985	1986	1987
Personal Income by Place of Residence	24954	25398	25855	26392	26951	27370	28149	24430	26149	28293
% Change	13.3	7.3	7.4	8.6	8.7	6.4	11.9	6.1	7.0	8.2
% Change from year ago	4.7	3.6	7.4	9.1	8.0	7.8	8.9			
Nonfarm Personal Income	23814	24216	24673	25211	25768	26187	26965	23297	24967	27108
% Change	6.8	6.9	7.8	9.0	9.1	6.7	12.4	6.4	7.2	8.6
Farm Personal Income	1140	1181	1181	1182	1182	1183	1184	1132	1182	1185
% Change	400.9	15.3	0	1	2	3	4	0	4.3	3
Earnings by Place of Work	17493	17881	18148	18591	19004	19292	19953	17003	18386	20068
% Change	19.0	7.2	6.0	10.1	9.2	6.2	14.4	6.5	8.1	9.1
% Change from year ago	6.0	4.1	8.9	11.0	8.6	8.4	10.0			
Wage and Salary Disbursements	13416	13612	13887	14275	14621	14831	15399	13035	14099	15488
% Change	9.5	6.0	8.3	11.7	10.1	5.8	16.2	6.5	8.2	9.8
Other Labor Income	1676	1712	1753	1776	1811	1856	1917	1627	1763	1926
% Change	8.8	8.7	10.0	5.5	8.0	10.3	13.9	7.8	8.3	9.3
Proprietors' Income	2401	2477	2500	2540	2572	2605	2637	2341	2524	2654
% Change	110.5	13.3	5.2	5.1	5.1	5.3	5.0	5.3	7.8	5.1
Farm Proprietors' Income	902	943	943	943	943	943	943	902	943	943
% Change	730.9	18.5	0	0	0	0	0	-2.0	4.5	0
Nonfarm Proprietors' Income	1499	1534	1565	1597	1629	1662	1694	1439	1581	1711
% Change	10.1	9.7	8.4	8.3	8.3	8.4	8.0	11.0	9.9	8.2
Less Personal Contrib for Social Insur	1123	1167	1198	1229	1257	1297	1336	1096	1213	1348
% Change	7.8	16.8	11.1	10.5	9.7	13.4	12.4	11.8	10.6	11.1
Plus Residence Adjustment	-111	-115	-120	-125	-129	-134	-139	-106	-122	-141
Dividends Interest and Rent	4375	4445	4532	4637	4745	4879	5038	4357	4590	5101
% Change	2.3	6.6	8.0	9.7	9.8	11.7	13.8	5.7	5.3	11.1
Transfer Payments	4320	4435	4494	4517	4586	4631	4640	4272	4508	4622
% Change	2.2	11.1	5.4	2.1	6.4	3.8	.8	6.1	5.5	2.5
State Unemployment Insurance Payments	111	115	120	95	95	106	99	121	106	85
% Change	-8.8	13.3	19.8	-60.5	-2.9	55.9	-24.4	8.9	-12.1	-20.4
Transfers excluding State UI Payments	4208	4320	4374	4422	4493	4525	4542	4151	4402	4537
% Change	2.5	11.0	5.1	4.5	6.6	2.9	1.5	6.0	6.0	3.1

WAGE AND SALARY DISBURSEMENTS

Wages and Salaries	13416	13612	13887	14275	14621	14831	15399	13035	14099	15488
% Change	9.5	6.0	8.3	11.7	10.1	5.8	16.2	6.5	8.2	9.8
Farm	233	233	233	234	234	235	236	225	234	237
% Change	11.0	.4	.2	.7	1.2	1.6	1.8	13.0	3.7	1.4
Nonfarm	13183	13379	13653	14041	14387	14595	15163	12810	13865	15243
% Change	9.5	6.1	8.5	11.9	10.2	5.9	16.5	6.4	8.2	9.9
Ag Serv,Forestry,Fisheries & Other	54	51	51	52	53	54	55	53	52	55
% Change	2.4	-19.4	-.1	6.5	7.4	7.2	5.0	5.0	-1.9	5.7
Mining	124	121	120	120	122	139	146	127	121	146
% Change	-2.6	-11.0	-.8	.1	5.2	67.4	21.0	3.3	-4.5	20.7
Construction	580	587	596	630	649	708	826	576	616	817
% Change	3.3	.8	6.7	24.8	12.6	41.6	84.5	10.4	6.9	32.7
Manufacturing	3674	3735	3793	3932	4000	4039	4189	3602	3865	4202
% Change	10.3	6.8	6.5	15.2	7.1	4.0	15.7	1.6	7.3	8.7
Nondurable Goods	1616	1675	1716	1791	1822	1841	1909	1612	1751	1915
% Change	4.5	15.7	10.0	18.7	7.0	4.3	15.4	.5	8.6	9.3
Durable Goods	2058	2060	2077	2141	2178	2198	2281	1990	2114	2287
% Change	15.3	.2	3.7	12.4	7.2	3.7	16.0	2.5	6.2	8.2
Transportation and Public Utilities	1093	1114	1144	1187	1229	1228	1269	1068	1169	1286
% Change	5.2	7.9	11.4	16.0	14.9	-1.0	14.8	6.2	9.5	10.6
Wholesale Trade	788	799	824	845	857	873	906	774	831	914
% Change	2.9	5.9	13.0	10.8	6.0	7.3	16.2	6.0	7.3	10.0
Retail Trade	1463	1486	1542	1585	1627	1623	1698	1416	1560	1715
% Change	12.1	6.3	16.0	11.7	11.0	-1.0	19.2	5.9	10.2	10.0
Finance,Insurance,and Real Estate	701	721	749	772	773	788	831	682	754	836
% Change	5.4	11.6	16.5	12.8	.6	7.8	23.5	10.2	10.6	10.9
Service	2010	2055	2104	2162	2246	2297	2385	1934	2142	2405
% Change	12.1	9.1	9.9	11.8	16.2	9.3	16.4	8.9	10.8	12.3
Government and Government Enterprises	2689	2711	2728	2734	2829	2848	2859	2580	2755	2866
% Change	12.2	3.2	2.5	3.9	11.4	2.6	1.6	10.4	6.8	4.0
Federal Civilian	524	520	515	515	527	534	563	506	519	566
% Change	15.2	-3.5	-3.8	.0	9.6	5.0	25.2	7.8	2.6	9.1
Federal Military	274	274	274	274	274	274	274	267	274	274
% Change	14.3	.0	.0	.0	.0	.0	0	4.1	2.0	0
State and Local	1891	1917	1939	1965	2029	2040	2020	1808	1963	2026
% Change	10.6	5.7	4.6	5.5	13.6	2.2	-3.7	12.4	6.6	3.2

income. Both farm prices and production will probably decline in response to lower loan rates and the set-aside provisions of the new farm bill.

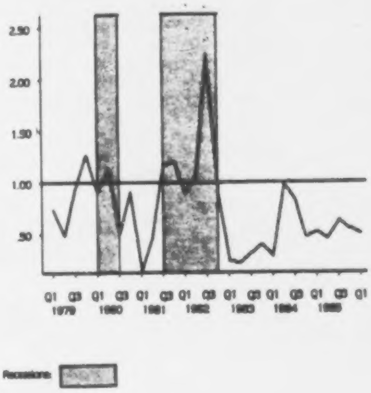
The real crisis in agriculture is in credit, not income, but Arkansas farmers appear to be in better shape than their counterparts in the rest of the country. A recent survey of ten farm states published by the Crop Reporting Service revealed that Arkansas farmers have the second lowest debt-to-asset ratio for farmers, 21 percent. A rate of 40 percent is considered to be dangerously high.

An additional risk that farm credit poses to the economy is that bad farm debt can lead to bank failures. This, in turn, could make investors raise their rating of the riskiness of private securities relative to riskless treasury bills, raising the rates at which business can borrow, reducing investment and slowing growth.

Whether the agricultural policy forged in Washington makes good economic sense from the point of view of efficient resource allocation, it appears to have kept private investors reassured about the riskiness of the farm situation. As shown in Figure 4, the spread between the rate at which the federal government borrows and the rate at which private business borrows remains at what should be regarded as normal levels. As can also be seen, the spread is highest during recessions, such as occurred in 1982.

Figure 4

Spread Between Private and Public Risk



MANUFACTURING:
A Bright Spot in the State's Economy

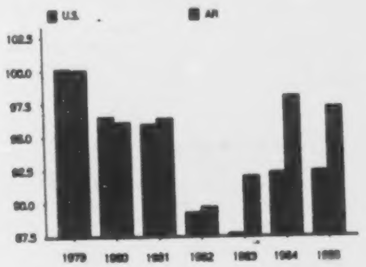
The current state of the manufacturing industry nationally offers a vivid illustration of the hazards of extrapolating national statistics to the state level. In the last quarter of 1985, there was a 3.5 percent decline in manufacturing output nationally and a 13.3 percent drop in the output of durable goods and a mere 0.6 percent increase in nondurables.

In contrast, Arkansas' fourth quarter was quite good with manufacturing employment growing at a seasonally adjusted annual rate of 11.0 percent. This relatively strong growth in Arkansas compared to the U.S. reflects some long-standing structural differences.

The loss of manufacturing jobs since 1979, both nationally and in Arkansas, is a well known fact. What hasn't been fully appreciated, though, is that Arkansas has done substantially better than the rest of the country in regaining those jobs. This is depicted in Figure 5 where employment is measured as a percentage of the 1979 level. As shown, both Arkansas and the U.S. lost manufacturing jobs each year from 1979 through 1982 and the U.S. continued losing jobs through 1983. By the end of 1985, however, Arkansas had regained 97 percent of the manufacturing jobs it had in 1979 whereas

Figure 5

Manufacturing Employment, Arkansas and the U.S., 1979-1985



the nation was only back to 92 percent. Even so, we are not forecasting a return to the previous peak level of manufacturing employment before 1988.

A leading cause of Arkansas' performance in manufacturing output and employment is unit labor costs. Table 2 shows that labor costs per dollar of output (unit labor costs) in Arkansas are substantially lower than the average for the U.S. This makes Arkansas a more attractive location for manufacturing plants. The force of these cost advantages is seen most dramatically in the food products and printing and publishing industries where employment growth has been extremely strong and the number of jobs now exceeds the 1979 level.

Table 2

Labor Costs Per Unit of Output (Selected Years 1967-1983)

Year	Arkansas	United States
1967	$0.43	$0.50
1972	0.41	0.49
1977	0.40	0.45
1982	0.36	0.46
1983	0.37	0.45

With so much attention focused on what is happening to inflation, interest and exchange rates, one factor that bodes well for manufacturing in the U.S. has been overlooked—the truly amazing price performance of manufactured products. As shown in Table 3, there has been very little change in the price of durable goods since the recession of 1982 and essentially no change in the prices of furniture and appliances. This contrasts sharply with housing and medical costs which have increased more than 20 percent.

Table 3

Selected Price Changes, 1982-1986

	Percent
All Items	13.7
Furniture and household equipment	0.3
Food	10.5
Housing	21.5
Medical Care	22.2

According to the University of Michigan's Institute for Social Research, the number of people who think now is a good time to buy household appliances because they are priced right, is at a historical high. With housing starts finally at rates consistent with the low mortgage rates available in Arkansas, the sales of appliances should increase rapidly.

GOVERNMENT:
A Drag on Growth

General revenue has not grown as fast this fiscal year as the state had anticipated when the budget was prepared. Revenue has grown only 3.9 percent, just slightly above the inflation rate. Fiscal Year 1986 has been an extremely difficult year for many states to forecast revenue—17 have had to cut back their enacted budgets. However, the experiences of the various states do not appear to have much in common. For instance, corporate income tax receipts of all states combined actually declined about 6.0 percent last calendar year while growing about 6.0 percent in Arkansas. Conversely, personal income tax and sales tax receipts have grown more slowly in Arkansas than the average of the other states.

Of course, state and local governments depend upon funds other than tax revenue to finance their expenditures. Federal grants, charges for services (water, sewer and other charges at the local level, and educational and health charges at the state level), fines, permit charges, etc. are important funding sources. Therefore, when examining governmental finances it is important to include these other funding sources.

The most recent data on governmental finance are for the 1984 fiscal year; therefore, we have made estimates for FY 1985 and FY 1986 to prepare the data shown in Table 4. The table shows both tax revenue and total general revenue (using the census concept of general revenue) for the state and local governments as a percentage of personal income. The census concept of general revenue includes general and special tax revenues, federal grants-in-aid, charges for government services, and miscellaneous income such as interest. This is shown in the table as "All Revenue." A fiscal year average of income was used to correspond to the fiscal year financial data.

Table 4

Revenue as a Percentage of Personal Income

	Tax Revenue		All Revenue	
	State	Local	State	Local
FY 1979	6.9	2.1	12.6	8.7
FY 1980	7.4	2.1	13.4	8.9
FY 1981	6.8	2.1	12.8	9.0
FY 1982	6.6	2.1	11.8	8.8
FY 1983	6.7	2.3	11.9	8.7
FY 1984	7.1	2.3	12.1	8.8
FY 1985	7.4	2.3	12.3	8.8
FY 1986	7.5	2.3	12.4	8.8

Although revenue as a percentage of personal income has risen over the last several years, it has not been sufficient to offset declines in federal aid. This is reflected in the decline in the tax rate (from all sources) of 12.6 percent in 1979 to an estimated 12.4 percent in the current fiscal year. Although this difference appears small, it represents $50 million. The table also shows a small increase in the general revenue of local governments from 2.1 percent to 2.3 percent of income. This has been sufficient to offset declining federal grants. The outlook, however, is for continued increases in state and local taxes as federal aid continues to decline. Another fact the table reveals is that the "tax rate" for the state is very cyclical. This gives a recession a double impact: not only does personal income decline—reducing the tax base—but the tax rate also declines.

State Spending Cuts

Much has already been written about the shortfall in state general revenue and the effect this will have on government spending. The shortfall is not great enough to affect essential government services (items in category "A" as prescribed by the Revenue Stabilization Act), nor will it require rescinding the scheduled 3.5 percent average pay raise for state employees on July 1st. But because general revenue has not grown sufficiently, various programs face cuts of about $45.7 million between February and the end of the fiscal year on June 30th.

It is very unlikely, however, that spending will be reduced by the full $45.7 million. Several agencies, such as the Education Department, have contingency funds that will enable them to make up some of the budget cuts. Other agencies, such as the state universities, have their own sources of revenue in addition to their state appropriations.

The federal government went through its first round of budget cuts mandated by the Gramm-Rudman-Hollings Deficit Reduction Act on March 1st. This was an across-the-board cut of 4.3 percent—defense was cut more and several entitlement programs were exempt. This roughly translates into similar size cuts in federal grants for Arkansas. Data on federal grants per capita for FY 1985 indicate that Arkansas receives close to the national average: $430 for Arkansas versus the national average of $417, with a range of $273 for Florida to $1,228 for Alaska. This means that across-the-board cuts in aid would have an average impact in Arkansas while it would disproportionately hurt Alaska at the upper end and would be disproportionately light on Florida at the lower end.

On the bright side, Arkansas received a windfall in the settlement of the suit brought against EXXON by the U.S. Department of Energy for overcharging customers for oil products. Arkansas received $26 million from the fine. Although the court stipulated this money be used for energy related programs, it will in time release some state funds for spending elsewhere.

Finally, lower inflation means not only lower revenues but lower interest rates. It may be useful for the state and local governments to consider the wisdom of calling outstanding bond issues early and refinancing their debt.

Macroeconomic Effects

Government and government enterprises—federal, state and local—account for about 11.0 percent of Arkansas' Gross State Product, divided between the federal component of 3.5 percent, and state and local of 7.5 percent.

The greatest impact of government on the economy is through employment and compensation of workers. Fifteen percent of the nonagricultural jobs in the state, accounting for 14 percent of total wage and salary payments, are with state and local governments. But government spending for goods and services also makes a significant impact upon the state's economy, particularly on the construction industry. In fact, as shown in Table 5, government purchases impact upon most sectors of the Arkansas economy.

Table 5

State and Local Government Purchases

	Percent
Total purchases	100.0
New construction	28.4
Maintenance and repair	11.2
Manufactured products	21.3
Professional services	13.2
Finance, insurance and real estate	7.5
Business services	6.2
Utilities	4.7
Transportation	3.4
Trade and other	4.0

The budgetary problems will probably not result in any loss of jobs in government nor any declines in salary—at least not at the state level. Furthermore, since a large portion of the construction industry in Arkansas is highway construction and repair, which is financed through dedicated federal revenue and state special revenue, there will not be much of an impact on the industry. Motor fuel taxes (both federal and state) are up considerably because of increased fuel consumption and higher taxes. This revenue will provide the Highway Department with the funds to continue its program over the next two years.

The situation for other purchases is a different story, however. Although government expenditure is forecast to rise 5 percent this year over FY 1985, most of the increase will be in higher payrolls and construction. The net increase for all other purchases is only about 2.1 percent, a decline in real dollars.

TAX FREE GOVERNMENT BONDS:
More a Political Than an Economic Issue

The recent Arkansas Supreme Court decision that all municipal and county bond issues require voter approval caused quite a stir in financial and legal circles. Revenue bonds for both public and industrial development purposes and the so-called "tourism" bonds were all included in the decision.

The court's clarification of its decision, making it clear that it did not apply to bonds issued under previous decisions of the court, did calm the waters somewhat. However, promoters of industrial revenue bonds claim the state derives substantial gains in economic development from the bonds with essentially no cost to the state. It may be true that the cost to Arkansas is negligible but the net effect of all states using their credit rating to borrow funds for private investors at lower rates of interest is to raise the interest rate at which the public can borrow. Although this practice may be justified on the grounds that Arkansas' participation is necessary to meet the competition of other states, it would be in the nation's best interest (and ultimately the best interest of Arkansas) if all states were prohibited from this type of arbitrage.

In any event, the success or failure of the current effort to override the court's decision with a constitutional amendment will not affect this forecast. In fact, if the effort fails it might well result in an improved tax base at the local level.

UALR's
ECONOMIC SERVICES SCHEDULE, 1986

Date	Event	Location
May 29	Use of Personal Computers in Generating Forecasts Seminar	Little Rock
July 15	Third Quarter Preforecast Conference	Little Rock
October 14	Fourth Quarter Preforecast Conference	Open
Fall	Use of Economic Forecasts in Business Planning Seminar	Open

The national forecast in this newsletter is taken from the Quarterly Model Outlook produced by Wharton Econometric Forecasting Associates, Inc., Philadelphia, Pennsylvania.

The state forecast is derived from the Arkansas Short-Term Forecasting Model, a product of the Regional Economic Analysis Division of the University of Arkansas at Little Rock.

The interpretation of the forecast is solely that of the authors and does not necessarily represent the views of Wharton or UALR.

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STATEMENT

BY

FLOYD W. LEWIS

CHAIRMAN OF THE BOARD AND PRESIDENT

MIDDLE SOUTH UTILITIES, INC.

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

OF THE

UNITED STATES SENATE

JULY 23, 1985

I am Floyd W. Lewis, Chairman of the Board and President of Middle South Utilities, Inc. I appreciate having the opportunity of testifying before the Committee on Energy and Natural Resources. This Committee has scheduled this hearing to examine the general question "When Will The Lights Go Out?". However, I have been requested to focus my remarks more specifically on issues regarding the Grand Gulf Nuclear Station and the recent Federal Energy Regulatory Commission's decision regarding the allocation of the costs of Grand Gulf Unit 1 among the Middle South operating companies.

GENERAL

Middle South Utilities, Inc. (MSU) is a holding company registered under the Public Utility Holding Company Act of 1935 and neither owns nor operates any physical properties. MSU owns all of the outstanding common stock of four operating electric utility subsidiaries, Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company

(MP&L) and New Orleans Public Service Inc. (NOPSI), and of Middle South Energy, Inc. (MSE), a generating company formed in 1974, which has been constructing and financing its 90 percent ownership interest in the Grand Gulf Station. The work of designing, constructing, operating and maintaining Grand Gulf Station is being performed by Mississippi Power & Light Company under contract as agent for MSE.

The term "Middle South System" is generally used to refer to MSU and its various direct and indirect subsidiaries. The electric generation and transmission facilities of the Middle South System are planned and constructed on a coordinated basis and are operated on a fully integrated basis from a dispatching facility located in Pine Bluff, Arkansas.

BACKGROUND

Prior to the 1970's, substantially all of the Middle South System's generating facilities were built to burn natural gas as the primary fuel. As it became more difficult to secure long term natural gas contracts, it was recognized in the late 1960's that the companies needed to diversify their fuel base.

In 1967 a decision was made to construct a nuclear generating unit in Arkansas, the first such unit in the Southwest part of the country. In 1970 a decision was made to build a second nuclear unit in Arkansas and to construct the first nuclear unit in Louisiana, Waterford 3.

During the late 1960's and early 1970's the peak system demand was growing at approximately 10 percent per year and was forecast to grow at about 9 percent per year through the decade of the 1970's and into the 1980's. Lead times for nuclear plants were considered to be approximately six to eight years.

Studies in this time frame showed that nuclear power plants would produce electricity at considerably lower costs than fossil fuels, including coal.

Based on these load forecasts and cost studies, two more nuclear units were planned. One was to be located at the current Grand Gulf site which is just outside Port Gibson, Mississippi and would be owned by MP&L and scheduled for commercial operation in 1979. The other would be located in South Louisiana, owned by NOPSI, and scheduled for commercial operation in 1980. Both of these units were to be 1250 megaw .t units.

In 1972 further studies showed that construction costs would run approximately 25 percent higher for the South Louisiana site than the Grand Gulf site primarily because of poor soil conditions. Because of these cost considerations, a decision was made to locate both units at the Grand Gulf site, with the first unit to be in operation for the peak season of 1980.

These decisions to construct nuclear units were reinforced by subsequent developments. Through the 1970's, the supply of natural gas for electric generation became increasingly scarce and deliveries of gas to the operating companies were curtailed by their suppliers. In January, 1973, the Federal Power Commission promulgated guidelines for curtailment of natural gas service by interstate natural gas pipelines which accorded the lowest priority to gas used for generation of electricity.

Also, during the 1970's the actions of Congress and the Executive Branch of Government greatly impacted our planning and decision making process. Using the Congressional Quarterly Almanac, we have summarized, by years, major federal legislative and executive actions directed at electric utilities with respect to their continued use of oil and natural gas as boiler fuel. This information is appended as Attachment 1. Laced throughout the various Congressional and Executive Branch proposals for solving the energy crisis was the common thread that utilities must stop using oil and gas as boiler fuel.

Historically, the construction and financing of all new generation have been the responsibility of each operating company. Units were sited on the basis of need to meet peak demand, optimal location of the new capacity and ability to finance. Generation expansion plans are coordinated by the Middle South Operating Committee, comprised of representatives of each of the operating companies and MSU.

Because of the sizes and projected capital costs of new nuclear units, it was realized that the smaller operating companies such as MP&L and NOPSI would have a difficult, if not impossible, time financing these units. This could leave them in the untenable position of having to rely on gas and oil for all future needs. As a result of studies undertaken to resolve this problem, it was determined that ownership of the Grand Gulf project by a new MSU subsidiary was the most desirable alternative.

FORMATION OF MSE

MSE was formed on February 11, 1974 as a wholly-owned subsidiary of MSU and activated in the middle of that year following receipt of the Securities and Exchange Commission's approval under the Public Utility Holding Company Act of 1935. At that time, the express purpose of MSE was to construct, finance, own and operate certain future base load generating facilities for the Middle

South System. In particular, MSE was created as a means of handling the financing of the Grand Gulf project, then in its initial stage of construction near Port Gibson, Mississippi and owned by MP&L.

As indicated above, the cost of the two 1250 megawatt Grand Gulf nuclear units was too great for MP&L alone to finance. Cost estimates at that time indicated that the first unit alone would cost approximately one and a half times the amount of MP&L's 1973 year-end net plant account. In fact, it would have been impossible, considering the size of the individual System operating companies and the other construction activities within the MSU System, for any of the System operating companies individually to finance a project of this magnitude in the time frame of the proposed construction schedule. It was determined that ownership of the project by a new MSU subsidiary - i.e., MSE - was the most desirable alternative. Effectively, the new subsidiary would have the full financial backing of the entire Middle South System. In June 1974, MSE, with the approval of the Mississippi Public Service Commission, purchased the Grand Gulf Station from MP&L at a cost equal to the original book value totaling approximately $20 million and in addition, contracted with MP&L, as agent, to design, construct and operate the Grand Gulf project, on MSE's behalf. MSE's only activity to date has been limited to the Grand Gulf project.

An application for the requisite nuclear construction permit was filed by MP&L with the Atomic Energy Commission in November 1972, and was later joined by MSE. MSE and MP&L, after a public hearing, received a certificate of public convenience and necessity from the Mississippi Public Service Commission in May 1974. On September 4, 1974, the Atomic Energy Commission issued construction permits for both Grand Gulf units and full scale construction was begun in late September of 1974. At that time, the construction schedule called for 64 months to commercial operation of Unit 1 at an estimated cost of $880 million.

MSE entered into a series of agreements with MSU and the System operating companies which have been used to provide the credit support necessary for MSE to enter the capital markets. MSU and MSE entered into a Capital Funds Agreement whereby MSU agreed to supply sufficient capital for MSE to (1) complete and operate the Grand Gulf project, (2) maintain an equity capitalization ratio of 35 percent and (3) repay, at maturity, notes under the U.S. Bank Loan Agreement, MSE's principal source of debt capital to finance the Grand Gulf project.

To provide additional credit support for MSE, the operating companies and MSE, in 1974, entered into the Availability Agreement, whereby MSE agreed (1) to make available to the System operating companies all power available from its share of the Grand Gulf Station and (2) to enter into a System Agreement with the System operating companies prior to commercial operation of Grand Gulf Unit 1. The System Agreement among the operating companies provides for, among other things, the basis for allocation of power among all the Companies and for the terms of payment for this power. In return, the System operating companies agreed to pay MSE monthly for the right to receive power available at the Grand Gulf Station and such amounts, when added to amounts received from other sources, would be at least equal to MSE's total operating expenses and interest charges with respect to the Grand Gulf Station.

The Availability Agreement, as amended in 1981, provided that the sale of power may be governed by a separate power purchase agreement (Unit Power

Purchase Agreement] rather than the System Agreement and also fixed the allocation percentages as follows: AP&L - 17.1 percent, LP&L - 26.9 percent, MP&L - 31.3 percent and NOPSI - 24.7 percent. These allocations were amended later in 1981 under a Reallocation Agreement whereby AP&L relinquished its rights, benefits and interest in the project and LP&L, MP&L and NOPSI assumed all the obligations of AP&L with respect to its responsibilities under the Availability Agreement. AP&L was, however, still to be obligated to make its share of the payments if the other operating companies were unable to meet their contractual obligations in this respect.

The System operating companies also entered into a Power Purchase Advance Payment Agreement with MSE whereby, in accordance with the percentages specified in the Reallocation Agreement, if Grand Gulf Unit 1 were not placed in commercial operation by December 31, 1983, such companies would make advance payments to MSE for power purchases in the aggregate of $12.5 million per month. Such payments would continue until December 31, 1984, later extended to December 31, 1985, or commercial operation of Unit 1, whichever occurred earlier. Repayment of power purchase advance payments made to MSE will be subordinated to the payment in full of all loans under the U.S. Bank Loan Agreement, including interest thereon. However, after commercial operation, MSE will be permitted to credit accumulated power purchase advance payments over an 18-month period to the appropriate System operating companies, including interest, against their respective obligations to pay for capacity and energy from Grand Gulf. As a result of the above arrangements, MSE had the financial strength to complete Grand Gulf Unit 1. With this structure, MSE was able to raise much larger amounts of capital than any one System company could have done.

MSE's future activities will be determined to a large extent, by the treatment of the recent FERC decision on the Unit Power Sales Agreement and the System Agreement proceedings by the various state and local regulatory bodies. Resolution of the federal preemption issue will be paramount in determining the viability of MSE as a vehicle for pursuing the System's future generation expansion plans.

ALLOCATION OF GRAND GULF

As stated above, the original Availability Agreement, as filed with the Securities and Exchange Commission (SEC) in 1974 (File No. 70-5399) anticipated that, on or prior to commercial operation of Grand Gulf Unit 1, MSE would become a party to the then existing 1973 System Agreement. Under that System Agreement, MSE would have had no load responsibility and, hence, all of MSE's Grand Gulf capacity and energy would have been purchased by the operating companies in proportion to their relative deficiencies in capability (each company's proportionate share of System capability less actual company capability). These company allocations would have changed frequently as the operating companies' load responsibilities changed due to different weather conditions and growth rates and as capabilities changed because of the addition and retirement of generating units and changes in the amounts of purchases from non-affiliated entities. It subsequently became apparent that the "floating" allocation of Grand Gulf capacity under the 1973 System Agreement would have resulted in frequent rate proceedings, involving both rate increases and decreases.

Furthermore, other factors also led to reconsideration of the original allocation methodology.

Because nuclear and coal generating units have a higher capital cost, but lower fuel costs than oil or gas generation, their costs to produce energy are highest in the early years of operation, before they are appreciably depreciated, and lower in the later years. Also, the fuel costs for nuclear power are much less than fossil fuels and are expected to increase at a much lower rate in the future. For these reasons, it was decided to allocate permanently the capacity from Grand Gulf among the operating companies so that the company which paid for the capacity in the early years, when it was more expensive, would have this same capacity in the later years, when it was less expensive.

Subsequent to the 1973 Arab Oil Embargo, the cost of natural gas and oil was escalating rapidly. The future availability of these fuels in adequate, assured amounts was a matter of serious national concern. The Power Plant and Industrial Fuel Use Act of 1978 prohibited the use of natural gas as a primary energy source in any existing electric power plant after January 1, 1990* and prohibited immediately the construction of any new power plants which burned either oil or natural gas. This further reinforced the decision to construct base generating units fueled with nuclear and coal as rapidly as the units could be financed.

*This provision was not repealed until 1981.

Thus, it was determined that each operating company should move towards having, through purchase or installation, its proportionate share of nuclear and coal-fueled base generating capacity. If MSE had become a party to the 1973 System Agreement it would have taken what was considered an unreasonable time for "long" companies (those companies whose generating capability exceeds their proportionate shares of total System capability) to participate in Grand Gulf's low fuel cost nuclear energy. These "long" companies would have been precluded from having the nuclear base generation that they would need to minimize fuel cost and to diversify their fuel base. This problem was made more acute because of the slow-down in load growth and the tremendous rises in oil and gas prices following the 1973 Arab Oil Embargo. If the companies "long" on gas and oil-fueled generation were to have timely access to nuclear base generation, thus minimizing their fuel cost, it was necessary to allocate Grand Gulf on a fixed basis. Further, the price of oil again skyrocketed in the fall of 1979, as a result of the turmoil in Iran. This event emphasized the desirability of completing the Grand Gulf project notwithstanding the repercussions resulting from the TMI incident.

The Chief Executive Officers of the Middle South System companies, in January, 1980, agreed to a fixed allocation of Grand Gulf, which was embodied in the 1981 Reallocation Agreement. Over several years prior to that agreement, many studies were performed based upon various actual and forecasted conditions, various assumptions and various allocation and equalization methods. These studies considered a number of alternatives which, respectively, resulted in certain advantages and disadvantages for the operating companies. The common thread which ran through all of these studies was the overall objective to achieve a fair and equitable allocation of the Grand Gulf capacity and energy among the Middle South operating companies. As would be expected, the results of the various studies were the subject of extensive discussion among the companies and the final allocation was arrived at by negotiation, with each company keeping its common and separate interests in mind. The final allocation was the result of a review begun in late 1979 based on the following goals:

1. To move each operating company toward having its proportionate share of coal and nuclear base generating units.

2. To assure the benefits of base generation's lower and more stable fuel prices to operating companies not otherwise having adequate base generation.

3. To reduce the difference in the fuel price of energy among the operating companies.

The final proposed allocation was incorporated into a Unit Power Sales Agreement executed on June 10, 1982 and filed with the FERC on June 18, 1982 in FERC Docket No. ER82-616-000.

FERC LITIGATION HISTORY

The genesis of what came to be known as "the Grand Gulf Case" was the proposal to sell all of the capacity and energy (power) available to MSE from Grand Gulf to LP&L, MP&L and NOPSI pursuant to the June 10, 1982 Unit Power Sales Agreement (UPSA). The UPSA provided that each purchaser would pay its proportionate share of the total cost of power from each unit, as defined in that agreement. The shares of power available to MSE from Grand Gulf under the UPSA which would have been purchased by LP&L, MP&L and NOPSI, respectively, are as shown in Attachment 2.

By Order issued August 25, 1982, the Commission accepted MSE's UPSA and related Billing Format for filing, found that the filing constituted a rate change rather than an initial rate filing and suspended the rates to become effective, subject to refund, upon the initiation of service from Grand Gulf.

The start of the other FERC case (the "System Agreement Case") was the filing with the FERC of a revised System Agreement on April 30, 1982 in Docket No. ER82-483-000. The System Agreement sets forth the terms and conditions for transactions among the four MSU operating companies. Transactions among the companies have been governed by some form of system agreement for over 30 years. The system agreements have provided the contractual basis for the coordinated planning and operation of the companies' generating units and also have provided a basis for equalizing certain cost imbalances that result from this method of planning and operating the units.

The two cases proceeded contemporaneously. The hearing in the Grand Gulf Case lasted 18 days and fills some 2,900 pages of testimony. The hearing in the System Agreement Case went on for 45 days, and its transcript is more than 7,000 pages long. The two cases together involved the filing of more than 640 exhibits. There were 22 parties in the Grand Gulf Case and 29 parties in the System Agreement Case.

The major objection of many of the intervenors in the Grand Gulf Case concerns the decision to sell all of MSE's Grand Gulf output only to LP&L, MP&L and NOPSI, and none to AP&L. Presiding Judge Liebman concluded (in February 1984) that, based on the evidence that the Middle South System is a single integrated and coordinated electric system operating in Louisiana, Mississippi, Arkansas and Missouri, the costs of Grand Gulf capacity and energy should be shared equitably by all four operating companies and their customers. After finding the proposed entitlement percentages unjust, unreasonable, and unduly discriminatory, the judge adopted the allocation proposal of the Louisiana Public Service Commission (LPSC) and Occidental Chemical Corporation (OCC) for Grand Gulf Unit 1. Judge Liebman's recommended allocation is shown on Attachment 2. The effect of the judge's decision was not just to allocate Grand Gulf costs, but to allocate the cost of all nuclear capacity on the MSU system. The positions of the intervenors in the System Agreement Case ranged from complete equalization of all System production costs to acceptance of the agreement as filed.

Presiding Judge Head, in February 1985, set forth his recommended Grand Gulf allocation plan which, based on 1984 energy demands, would have resulted in the allocation shown on Attachment 2. He also recommended approval of the System Agreement as filed with only minor changes.

A January 1985 filing (prior to Judge Head's decision) of a Proposed Offer of Settlement by MSU subsidiaries to settle the allocation issue called for stockholders to absorb about one-third of the costs of Grand Gulf Unit 1 through December 31, 1990. Had the state regulatory and other parties accepted that offer, customers of the operating companies would have been charged initially for only 67.1 percent of the unit as follows: AP&L, 17.1 percent; LP&L, 14 percent; MP&L, 19 percent; and NOPSI, 17 percent. The stockholders' participation in cost sharing under this proposal would have ended effective January 1, 1991; and the operating companies would then have assumed additional allocations of: AP&L, 10.8 percent; LP&L, 13.5 percent; MP&L, 5.4 percent; and NOPSI, 3.2 percent.

MSE and the operating companies participated actively in a settlement conference convened by the FERC and attended by all the parties in March of this year. In announcing that settlement conference, FERC Chief Administrative Law Judge Curtis L. Wagner, Jr., said "There is absolutely no question concerning the fact that a negotiated settlement of these very complex and difficult proceedings will be in the public interest." A number of alternative settlements were offered and discussed during the course of the conference, but the principal issues remained unresolved after two days, and the conference was ended by Judge Wagner without a settlement.

On June 13, 1985, the FERC issued its Opinion and Order concerning both cases. The Commission affirmed Judge Head's findings rejecting the various allocation proposals in the System Agreement case and approving the System Agreement as filed, with only minor changes. The Commission then rejected Judge Head's Grand Gulf allocation in favor of Judge Liebman's decision, giving AP&L a 36 percent allocation, LP&L a 14 percent allocation, MP&L a 33 percent allocation and NOPSI a 17 percent allocation.

Subsequent to the FERC decision, the Middle South Utilities System again offered to allocate certain costs from Grand Gulf to the Middle South Utilities, Inc. stockholders. This would have had the effect of reducing the percentage allocations of each company until 1995. As a part of this offer, the issue of prudency would be resolved by the FERC and the allocated costs of Grand Gulf Unit 1 would be promptly reflected in retail rates. None of the regulatory bodies accepted this offer.

JURISDICTION

The reason for the institution of federal authority over utility transactions was the existence of an area of the utility business which was beyond the scope of state regulatory authority. In this sense, federal regulation is supplemental. Thus, in determining whether or not any matter should be reviewed by federal or state authorities, it is proper to study whether or not issues concerning the particular project under review can be resolved at the state level. The Grand Gulf proceedings give us an excellent example of a project which cannot be regulated at the state level without fragmentation and the resulting disregard of the advantages of interstate operation. If each state in a multistate project is given an effective veto over a project of this scope, which it is free to exercise in pursuit of its own parochial interests, interstate commerce would be severely constrained. It could not have been the intent of Congress, in recognizing the states' regulatory roles, to give a blanket authorization to state actions which are serious barriers to interstate commerce. On the contrary, by encouraging pooling and other such cooperative efforts, Congress has recognized the benefits of such commerce. Turning ultimate regulatory authority over such projects to protectionist state commissions would fly in the face of the Commerce Clause of the U.S. Constitution and result in a fragmented and less efficient electrical system to the detriment of the country. Regulation of a multistate project can only be carried out impartially and in the national interest by a regulatory body which can examine all facets of such a project. Only exclusive review by a federal agency such as the FERC is appropriate where many states are involved.

CONSTRUCTION PRUDENCY

Since the cost and schedule for constructing Grand Gulf has changed significantly since the inception of the project, the Mississippi Public Service Commission initiated a construction audit of the project in late 1984. In April, 1985 the Commission's consultants issued their report, which included the following major conclusions:

- "In general, all significant cost and schedule increases on Grand Gulf were due to factors associated with the growth of the nuclear power industry during the 1970's and early 1980's and not to factors unique to the project itself."
- "Factors causing major cost escalation and schedule slippage were industry-wide in nature and beyond the direct control of MP&L."
- "Review of the project indicates that MP&L took measures to minimize the cost and schedule effects of industry-wide events and other impacting factors."
- "While a number of project activities were performed by others, MP&L adequately planned, participated in and managed these activities, and met the evolving needs and demands of Grand Gulf."

In comparing the schedule of Grand Gulf Unit 1 with recent industry data, the consultants found that:

- "For units which began in the same time frame as Unit 1, the total project duration (NSSS award to commercial operation) of Unit 1:
  - is five percent less than the industry average for all units
  - is two percent less than the industry average for BWR units"
- "For units which were or will be completed within the same time frame as GGNS Unit 1, the total project duration of Unit 1:
  - is seven percent less than the industry average for all units
  - is 11 percent less than the industry average for BWR units"

Additional details are included in the Executive Summary of the Grand Gulf Construction Audit, a copy of which is appended as Attachment 3.

PRUDENCE OF PAST DECISIONS

"Prudence" is a term we have heard in a number of forums recently. The meaning of the term varies with the speaker. Some would contend that the only prudent decision is a decision which is judged to be best by all parties viewing it from hindsight. Such equating of prudence with clairvoyance not only offends basic notions of fairness, but creates untoward practical difficulties in the area of financing large projects. The current harassment of virtually every utility with significant construction work bears witness to this. Certainly no regulatory body on earth could function if this standard were to be applied to its own decisions. In addition, such regulation from hindsight is constitutionally infirm in that it impairs freedom of contract and creates new legal duties attaching to past events. (See Attachment 4).

Prudence, in a regulatory framework, should not mean perfection in the eyes of a particular regulator. A more fitting standard would be the one now employed by the FERC and other enlightened regulators: "Was the decision, in light of all factors known or properly knowable at the time the decision was made, a reasonable decision?". Regulation should seek to root out self-seeking abuses of power, not to second guess well thought-out-decisions made with the best interest of utility customers and shareholders at heart.

We believe the Grand Gulf project can be shown to be prudent under any reasonable standard. Fulfillment of our legal duty to serve in the changing world created by international cartels, uncertain fuel supplies, and new governmental restraints was a primary factor in determining to launch upon a program of fuel diversification which included Grand Gulf. Gaining the long term benefits of price stability in this climate was certainly prudent. Long term security for the purchasers of our power cannot be gained through a series of short term purchases from suppliers remote from our service area. No matter how attractive these one shot purchases are momentarily, reliance on these will, we believe, in the long run prove detrimental in terms of both reliability and cost as these supplies become constricted by growing demand on the suppliers' systems. This growth will come relatively quickly in relation to the lengthy utility planning horizon. Membership in a unified system of utilities, which support each other by the maintenance of sufficient capacity margins, is by far the wiser course. We would urge regulators not to devalue long term benefits. Seeking the current lowest cost, without regard to other considerations, may turn out to be very costly indeed in the long run.

CONCLUSION

With the recent completion of Grand Gulf Unit 1 and Waterford Unit 3, the Middle South System has achieved a major milestone in an extensive program of fuel diversification, consistent with national priorities and designed to reduce electricity costs over the long-term. At the time of severe curtailments of natural gas for power plant fuel in the early 1970's and of the Arab Oil Embargo in 1973, all of the System's steam-electric generating units were fueled with natural gas with oil as back-up fuel. Since then, we have completed four nuclear units and four coal units, our shares of which represent 3,923 megawatts of nuclear capacity and 1,894 megawatts of coal capacity. Thus, about 37 percent of the System's total installed capability is now in the form of coal and nuclear units.

After more than a decade and a half of working on this program of fuel diversification during one of the most difficult economic periods in our history, we now are confronted with the ultimate paradox. Largely because of similar fuel diversification programs throughout the world, gas and oil are now available in abundant supplies and current prices are substantially below those projected just a few years ago by all the experts we could find. Our actions are being attacked as imprudent and unnecessary. Yet, if utilities had not embarked on oil and gas displacement programs, these high price forecasts would probably have materialized and the same voices would now be criticizing us for imprudently relying upon high priced petroleum products.

We have been accused of trying to avoid regulation of Grand Gulf. Yet the record is clear that, since 1972, we have sought and received all requisite approvals. Three years transpired between the filing of the Unit Power Sales Agreement and the recent FERC decision. All interested parties diligently pursued their respective interests in the FERC proceedings. The System put forth settlement offers in January, 1985 and again in June, 1985, after the FERC decision, whereby the stockholders would absorb some of the Grand Gulf costs. None of the parties accepted these offers.

Given the fact that the MSU operating companies conduct business in separate states, and given the dual system of state and federal rate regulation, the positions of the parties can be conveniently grouped on a state-by-state basis. Each of the state/party groups shares a common view that customers in its own state should have less responsibility for the costs of Grand Gulf, while customers in the other states should have more cost responsibility.

A major problem confronting us and all electric utilities is the planning horizon associated with construction of generating facilities. Traditional utility planning considers "life-cycle economics" over a 30-40 year span. Yet, others tend to look only at short-term effects in assessing the wisdom of our decisions.

Contrary to widespread public belief, the use of electricity is still increasing--granted, not at the high levels of the 1950's and 1960's, but still at a respectable pace. Too many people erroneously equate this lesser rate of growth in electricity use as being a drop in electricity use.

Some of this confusion may be because non-electric energy use has fallen more than 15 percent since 1973. But during the same time frame, the use of electricity has actually gone up by more than 20 percent. Industrial use of total energy has decreased by 28 percent since the early 1970's. However, during the same period, the use of electricity by industry has increased by 16.6 percent. Clearly, our society is using less total energy today through conservation and the continued electrification of our homes and workplaces.

The growth in the Gross National Product is closely linked to similar levels of growth in the usage of electricity. GNP and electricity have had a strong correlation for the past several decades. When viewed on a graph, the two lines move almost in parallel--before 1973 when GNP grew at an average 4 percent a year, the use of electricity increased by an average of 7 percent a year. When GNP grew at 5 percent levels in the mid-1970's, so did electricity. And when GNP stagnated in the recent recession, the use of electricity also leveled off. Similarly, in 1984, when GNP rebounded to a 6.9 percent growth rate, electricity use increased nationwide about 6 percent. There are reports of some electric utilities having already experienced peak loads this year which they had not expected until late in the 1980's. Among our System companies only the smallest, New Orleans Public Service Inc., has not already exceeded its forecasted peak demand for 1985 and the hottest part of the year is normally yet to come at this point in time. LP&L has experienced a peak demand 3.7 percent above the highest level of all of 1984, and MP&L has exceeded its 1984 peak by 6.6 percent already.

Even at a growth rate of 2.5 percent annually, by the end of the century usage of electricity will have increased almost 50 percent. To meet that demand, the nation's utilities will need to build 300 more large generating plants than are currently under construction.

We believe there is very broad agreement among knowledgeable people that for sizable additions to electric generating capacity, coal and uranium are now the only two practicable fuels domestically available which are abundant and relatively stable in price and supply. But we must recognize that it takes an average of 8 years to design, build, and put into operation a coal-fueled plant and about 12 years or more for a nuclear plant in this country.

I have already mentioned the impending need for more generating capacity before the year 2000. What will also be needed before utilities will renew their construction programs and undertake the risks involved with lengthy construction lead times is the front-end involvement on the part of enlightened utility regulators who will measure the worth of such long-term decisions in context with the long-term benefits.

We all know that unless major changes are made, new nuclear plants are not likely to be started in this country, while the rest of the world marches forward on electricity from uranium. And some of the same problems constrain our decisions on non-nuclear base load plants as well, particularly coal plants. We cannot solve all the regulatory, financial and political problems that are restricting the utility industry's ability to install major new capacity in a vacuum; the positive steps that we need, especially on nuclear power, will require a broad base of understanding and support from legislators, regulators and the public.

The country needs to face up to this serious long-term dilemma: Electrical demand is growing in parallel with our GNP at the same time that the financial and regulatory climate is discouraging utilities from taking investment steps to meet that demand reliably and economically over the long-term. It is not just the utility industry that is being trapped between these pressures. Ultimately, it is our entire economy that could suffer.

Senator **Bumpers**. Peter.

STATEMENT OF PETER A. BRADFORD, CHAIRMAN, MAINE PUBLIC UTILITIES COMMISSION AND FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. **Bradford**. Senator Bumpers and Senator Pryor, my name is Peter Bradford. I am chairman of the Maine Public Utilities Commission and first vice president of the National Association of Regulatory Utility Commissioners, on whose behalf I am testifying. I also served as a Commissioner on the Nuclear Regulatory Commission from 1977 until 1982.

While NARUC does not take a position with regard to the correctness of FERC's decision in the *Middle South* case and is consequently not commenting on those sections of S. 1149 that would legislatively overrule that decision, we do have serious concerns about some of the directions in which FERC has been moving with regard to interpreting its jurisdiction so as to interfere with important State ratemaking functions. S. 1149 is helpful in requiring a change in those directions.

The FERC proceeding in the *Middle South* case has two aspects which are irreconcilable with sensible State regulation, regardless of whether or not one approves of FERC's allocation of Grand Gulf costs between the affected States. Specifically, the major cost reallocations that that decision achieves 4 years after the fact are destructive of careful State decisionmaking on the day-to-day and week-to-week basis, which regulation really matters.

Second, FERC's refusal to do a prudency review while actively preempting the States from doing their own is beyond sober analysis. I will deal with the second point first.

The essence of utility regulation is to make utilities behave as if they had to function in a competitive environment. This result cannot be achieved if imprudent expenditures are passed on to customers. There are substantial prudency questions regarding Grand Gulf.

For FERC effectively to prevent any review of these questions while declining to make such a review itself makes a mockery of the entire purpose of utility regulation and tends to confirm the view of those cynics who feel that the real purpose of regulation is to legitimize conduct by utilities that the public would never accept in the absence of some semblance of Government endorsement.

Ratepayers throughout the Middle South system are, as to Grand Gulf, denied the most fundamental assurance that regulation is supposed to provide; namely, that their money is not being wasted on corporate imprudency on a massive scale. It is a failing every bit as serious in an economic regulatory agency as NASA's handling of the O-rings was in the context of that agency's responsibilities. If I were a FERC Commissioner, I would resign before I would continue to preside over a regulatory fiasco of that magnitude.

That having been said, let me refer to the first problem; that is, the delay between the time that Arkansas thought it was out of Grand Gulf and FERC's decision to equalize the price of nuclear power throughout the Middle South system.

All State commissions now make many decisions on an annual basis that are based on their best estimates of the cost of their State's power supply well into the future.

For example, we set both long- and short-term avoided cost rates pursuant to which the utilities in our States sign multiyear contracts to purchase power from third-party producers. Conservation programs and interruptible contract rates between utilities and their larger customers or classes of customers have a similar basis.

Furthermore, individual customers use existing and expected future prices as a basis for their own decisions on investments in energy-efficient equipment or energy conservation. A sudden, major rearrangement of the price of power coming after several years of State commission decisionmaking guarantees significant inefficiencies that will be damaging to the economies of the affected States.

In the case in question, it is almost inevitable that some energy-efficient projects in Arkansas have been foregone in the last few years because of assumed electricity prices that were too low when compared to the results produced by the FERC decision.

Likewise, investments have probably been in energy efficiency or self-generation in Louisiana that turn out not to be justified at the lower electricity prices that will prevail.

These are not decisions that can easily be unmade in light of the FERC decision. Building insulation or a lighting system that has been installed is not going to be ripped out as a result of a change in prices.

Consumers throughout the Middle South system have been given consistently misleading price signals during the very substantial time between the apparent transactions taking Arkansas out of Grand Gulf and FERC's decision to equalize nuclear power costs throughout the Middle South system. They have responded to these price signals in ways that are now sunk costs, just as surely as unit II at Grand Gulf is a sunk cost.

This kind of Federal decisionmaking, undoing several years of responsible State electric energy planning, is just not acceptable to NARUC. The consequences of the present debacle are not just the mispromised investments in the affected States. They include the likelihood that other States, watching what has happened here, will be far more reluctant to permit any expansion of federally-regulated arrangements in their own jurisdiction.

In this context, I should note that it is FERC's actions much more than your bill that are likely to dampen power pooling in the future. I can assure you that no Maine utility is going to get my permission to enter into any FERC-regulated arrangements that carry with them the potential for some after-the-fact reallocation of the Seabrook Nuclear Power Plant in New Hampshire or other nuclear costs to affect Maine in the way that the Middle South decision has affected the States in the Middle South system.

Maine has just approved the sale of its Seabrook share to a Massachusetts utility. Consequently, our position in relation to Seabrook is not unlike the position that Arkansas felt it was in in 1981 in relation to Grand Gulf. Should FERC attempt to use the New England power pool as a vehicle for reallocating Seabrook costs in the future in some way such as to flow additional Seabrook costs back into Maine, the provisions of NEPOOL that enable any utility to withdraw from that pool on 6-months notice are very likely to be used.

Thus, this type of FERC decisionmaking carries with it a real potential for unmaking the very types of regional pooling arrangements that FERC has, in other contexts, claimed to favor. This is an aspect of the *Middle South* case that has received no consideration that I can discern in any of the FERC opinions.

The long and short of it is that, both in its handling of the prudency matter and in its insensitivity to the impacts of the long delay on State energy policy, the *Middle South* decisions bespeak a major breakdown in the relationship between Federal and State electric utility regulations.

State commissions have a number of techniques available to them for sheltering their ratepayers from such problems in the future. However, these techniques by and large confront the utilities with a very difficult set of choices in terms of displeasing one or another set of regulators with significant control over their revenue flows.

It would be much better for FERC and NARUC to explore constructively improved ways of dealing with difficulties of this sort. The preemptive power of the Federal agencies is a force whose usefulness they tend vastly to overestimate. In the long run, the State commissions are closer both to the consumers and to the management of the regulated utilities.

We can gradually force rearrangements in utility management and corporate configurations that will offset Federal preemptive overtures that have generally unacceptable effects. For example, I have no doubt that if the affected States were determined to do it and we were well advised, they could put an end to the Middle South holding company within 5 years.

Consequently, no prudently run holding company or power pool will seek refuge in a perceived relative leniency at FERC for any long-term arrangement.

One vehicle for improving cooperation between Federal and State jurisdictions in a less acrimonous manner would be the implementation of joint board proceedings of the type now routinely employed by the Federal Communications Commission. While the ultimate decisionmaking power in such proceedings does reside with the FCC, and while this process continues to produce results that are not fully satisfactory to NARUC, the fact is that joint board processes do allow for a significantly greater awareness at the Federal level of major State concerns.

The FCC joint board format is that four State commissioners designated by the President of NARUC and 3 FCC commissioners meet to formulate recommendations to the FCC on particular subject matters, as determined initially by the Federal commission. As a result, there is a basis for continuing dialogue on issues of importance, both formally and informally at both the staff and commissioner level.

I do not think it is any coincidence that the FCC's worst problems in the telecommunications area came in two categories, access charges and intrastate depreciation rates, on which that commission chose to bypass the joint board process.

The results were, in the former case, a debacle in Congress, and in the latter a distinct rebuff from the U.S. Supreme Court. Both cases generated significant ill will in the process. Joint boards, especially if the States share in the power to call them into being, are a useful warning system to avoid such friction and inefficiency.

Another possible step toward a more constructive means of dealing with problems of this sort was outlined in a report of the National Governors Association on regional regulation, which NARUC endorsed 3 years ago. This approach would permit States to form regional compacts and, once having done so, to displace many FERC functions as to power pools or holding companies entirely within the jurisdiction of the member States of the compact.

This is a concept that Arkansas pioneered legislatively as to river basin compacts to deal with water pollution in the late 1960's and early 1970's.

Finally, I have some observations as to the general principles of such legislation. First, the *Narranganset* doctrine, read reasonably, is not harmful by itself. Dual jurisdiction can cause at least as many problems as it solves. However, States must remain free to review the prudency of entering into or remaining in the power purchase and other interstate agreements.

Second, it would be useful to end FERC jurisdiction over sales that are intrastate in nature, even if they are wholesale sales.

Third, the protections that you give States from holding companies should apply to power pools as well. The reasoning of the *Middle South* case will not necessarily be confined to holding companies by FERC in the future, so the legislation remedying the shortcomings in that case should not be so confined, either.

I appreciate the opportunity to testify on this matter and will be glad to answer your questions.

[The prepared statement of Mr. Bradford follows:]

UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON WATER AND POWER

TESTIMONY OF THE

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ON

THE RATEPAYER PROTECTION ACT OF 1985 (S. 1149)

July 23, 1986

My name is Peter A. Bradford. I am Chairman of the Maine Public Utilities Commission and First Vice President of the National Association of Regulatory Utility Commissioners, commonly referred to as the "NARUC", on whose behalf I am testifying. I also served as a Commissioner on the Nuclear Regulatory Commission. Accompanying me today is Phyllis Levine, NARUC Director of Congressional Relations.

Thank you very much for the opportunity to testify on S. 1149, the Ratepayer Protection Act of 1985. While I do not intend to take a position with regard to the correctness of FERC's decision in the Middle South case and consequently am not commenting on those sections of the bill that would legislatively overrule that decision, I do have serious concerns about some of the directions in which FERC has been moving with regard to interpreting its jurisdiction so as to interfere with important state ratemaking functions.

The FERC proceeding in the Middle South case has two aspects that are irreconcilable with sensible state regulation regardless of whether or not one approves of FERC's allocation of Grand Gulf costs between the affected states. Specifically, the major cost reallocations that that decision achieves years after the fact are destructive of careful state decision-making on the day-to-day and week-to-week basis on which regulation really matters. Secondly, FERC's refusal to do a prudency review while actively preempting the states from doing their own is beyond sober analysis.

The essence of utility regulation is to make utilities behave as if they had to function in a competitive environment. This result cannot be achieved if imprudent expenditures are passed on to customers. There are substantial prudency questions regarding Grand Gulf. For FERC effectively to prevent any review of these questions makes a mockery of the entire purpose of utility regulation and tends to confirm the view of those cynics who feel that the real purpose of regulation is to legitimize conduct by utilities that the public would never accept in the absence of some semblance of government endorsement. Ratepayers throughout the Middle South system are, as to Grand Gulf, denied the most fundamental assurance that regulation is supposed to provide, namely that their money is not being wasted on corporate imprudency on a massive scale. If I were a FERC commissioner, I would resign before I would continue to preside over such a regulatory fiasco.

Let me return for a moment to the first problem, that of the delay between the time that Arkansas thought it was out of Grand Gulf and FERC's decision to equalize the price of nuclear power throughout the Middle South system. Let me stress here that I am not quarreling with FERC's substantive decision. NARUC takes no position on the correctness of the result that FERC reached.

However, we do deplore the dislocations that are inherent in this type of decision-making. All state commissions now make many decisions on an annual basis that are based on their best estimates of the cost of their state's power supply well into the future. For example, we set both long and short term "avoided cost rates" pursuant to which the utilities in our states sign multi-year contracts to purchase power from third party producers. Similarly, we design conservation programs that are extensively based on the projections of power costs in the future. Likewise, we set interruptible contract rates between utilities and their larger consumers or classes of consumers that have a similar basis. Furthermore, individual customers use existing and expected future prices as a basis for their own decisions on investments in energy efficient equipment or energy conservation.

A sudden major rearrangement of the price of power coming after several years of state commission decision-making guarantees significant inefficiencies that will be damaging to the economies of the effected states. In the case in question, it is almost inevitable that some energy efficient projects in Arkansas have been foregone in the last few years because of assumed electricity prices that were too low when compared to the results produced by the FERC decision. Likewise, investments have probably been made in energy efficiency in Louisiana that turn out not to be justified at the lower electricity prices that will prevail.

These are not decisions that can easily be unmade in light of the FERC decision. A building that has been insulated or a lighting system that has been installed are not going to be ripped out as a result of the change in prices. Furthermore, motors that have been rewound will not now be scrapped simply because, in hindsight, the purchase of more energy efficient motors would have been the right thing to do. Consumers throughout the Middle South system have been given consistently misleading price signals during the very substantial time between the apparent transactions taking Arkansas out of Grand Gulf and FERC's decision to equalize nuclear power costs throughout the Middle South system. They have responded to these price signals in ways that are now sunk costs just as surely Unit II at Grand Gulf is a sunk cost. Consumers cannot undo these investments even though some of them are undoubtedly costly mistakes in hindsight.

This kind of federal decision-making, undoing several years of responsible state electric energy planning, is just not acceptable to NARUC. If FERC is to introduce dislocations of this magnitude into electric utility pricing, it must do so on a more timely basis. The consequences of the present debacle are not just the mispremised investments in the affected states. They include the liklihood that other states watching what has happened here will be far more reluctant to permit any expansion of federally regulated arrangements in their own jurisdictions.

I can assure you that no Maine utility is going to get my permission to enter into any FERC-regulated arrangements that carry with them the potential for some after-the-fact reallocation of Seabrook or other nuclear costs to affect Maine in the way that the Middle South decision has affected the states in the Middle South system. It is now clear to any state that has watched the Middle South situation closely that pooling arrangements or corporate reorganizations that might otherwise seem desirable carry with them a potential for belated FERC "equalizations" that will undo years of least cost planning in a manner about which FERC is either unaware of indifferent. It is likely that the marginal increases in efficiency that such arrangements might produce, desirable though they would be in themselves, are just not worth the risk of shocks of the Middle South magnitude.

Maine has just approved the sale of its Seabrook shares to a Massachusetts utility. Consequently our position in relation to Seabrook is not unlike the position that Arkansas thought that it was in in 1981 in relation to Grand Gulf. Should FERC attempt to use the New England Power Pool as a vehicle for reallocating Seabrook costs in the future in some way such as to flow additional Seabrook costs back into Maine, I assure you that the provisions that enable any utility to withdraw from the power pool on six months notice are likely to be used. Thus this type of FERC decision-making carries with it a real potential for unmaking the very types of regional pooling arrangements that FERC has in other contexts claimed to favor. This is an aspect of the Middle South case that has received no consideration that I can discern in any of the FERC opinions.

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The long and short of it is that - both in its handling of the prudency matter and in its insensitivity to the impacts of the long delay on state energy policy - the Middle South decisions bespeak a major breakdown in the relationship between federal and state electric utility regulation. State commissions have a number of techniques available to themselves for sheltering their ratepayers from such problems in the future. However, these techniques by and large confront the utilities with a very difficult set of choices in terms of displeasing one or another set of regulators with signficant control over their revenue flows. It would be much better for FERC and NARUC to constructively explore improved ways of dealing with difficulties of this sort.

One such vehicle would be the implementation of joint board proceedings of the type now routinely employed by the Federal Communications Commission. While the ultimate decision-making power in such proceedings does reside with the FCC and while this continues to produce results that are not fully satisfactory to NARUC, the fact is that joint board processes do allow for a significantly greater awareness at the federal level of major state concerns.

The FCC joint board format is that four state commissioners designated by the president of NARUC and three FCC commissioners meet to formulate recommendations to the FCC on particular subject matters as determined initially by the FCC. As a result, there is a basis for a continuing dialogue on issues of importance - both formally and informally - at both the staff and the commissioner level.

I don't think that it is any coincidence that the FCC's worst problems in the telecommunications area came in two categories - access charges and intrastate depreciation rates - on which that Commission chose to bypass the joint board process. The results were in the former case a debacle in Congress and in the latter a distinct rebuff from the U.S. Supreme Court. Both cases generated significant ill will in the process.

The preemptive power of the federal agencies is a force whose usefulness they tend vastly to overestimate.[1] In the long run, the state commissions are closer both to the consumers and to the management of the regulated utilities. We can gradually force rearrangements in utility management and corporate configurations that will offset federal preemptive overtures that have generally unacceptable effects. I have for example no doubt that, if the affected states were determined to do it and were well advised, they could put an end to the Middle South holding company within five years. Consequently, no prudently run holding company or power pool will seek refuge in a perceived relative leniency at FERC for any long term arrangement.

Another possible step toward a more constructive means of dealing with problems of this sort was outlined in a report of the National Governors Association on Regional Regulation which NARUC endorsed three years ago.

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[1] I have discussed this point and the Middle South case in more detail in a paper published in the proceedings of the 1985 Williamsburg Conference by the Institute of Public Utilities at Michigan State University.

This approach permits states to form regional compacts and, once having done so, to displace many FERC functions as to power pools or holding companies entirely within their jurisdiction. This is a concept that Arkansas pioneered legislatively as to river basin compacts to deal with water pollution in the late 1960's.

Finally, I have some observations as to the general principles of such legislation.

First, the Narragansett doctrine read reasonably is not harmful by itself. Dual jurisdiction will cause at least as many problems as it solves. However, states must remain free to review the prudency of entering into or remaining in the power purchase and other interstate agreements.

Second, it would be useful to end FERC jurisdiction over sales that are intrastate in nature, even in they are wholesale sales.

Third, the protections that you give to states from holding companies should apply to power pools as well.

The reasoning of the Middle South case is not necessarily confined to holding companies, so the legislation remedying the shortcoming in that case should not be so confined either.

I appreciate the opportunity to testify on this matter and will answer your questions as best I can.

Senator **Bumpers**. Thank you, Peter.

George, I never read the *Colton* decision. What is the rationale, incidentally, for FERC regulating intrastate wholesale sales?

Mr. **White**. I am not a lawyer, but what I remember from reading it is that you cannot trace a kilowatthour, an electron, and therefore once it is into the national grid system it is essentially interstate in character. That was the basis of it.

Senator **Bumpers**. I had not even thought about that, but I think that is a very interesting point. I see no reason for FERC to be dealing with that.

Mr. **Bradford**. It produces some very strange results in Maine, where very tiny electric companies who buy from the larger Maine companies have to come to Washington to participate in reviews of the rates at which they purchase. Little islands that buy by cable, mainly, are regulated by FERC.

Those kilowatthours may not be traceable but neither are the kilowatthours sold within the Central Maine Power Co. system or within the Bangor hydroelectric system. It would certainly be a better system of regulation for this transaction to be handled in Augusta than in Washington, and they probably have similar problems in Arkansas.

Senator **Bumpers**. Can you clue us in, George, to what Middle South will do with Grand Gulf II?

Mr. **White**. Senator, we have suspended construction on Grand Gulf II. Essentially, no more work has been done on that since 1979. We are studying everything we can on ways to reduce the cost or what to do.

Senator **Bumpers**. Did you read what your boss said in Forbes magazine?

Mr. **White**. He said, to paraphrase it and what I have heard him say in other places, that Grand Gulf II, as we know and love it, probably will not be built, and I think that is an accurate statement. There are all kinds of other things you can do, such as selling off equipment or putting another type of unit there to salvage some of the cost, and those things are being studied. There simply has been no decision on that.

Senator **Bumpers**. You went a little further than that, George. You said he intends to save the concrete slab on which the plant was to have been built for another powerplant sometime in the future. "What we are trying to do," says Lupberger, "is to get the residue of that $950 million down as small as we can so that the consumer never sees it and it doesn't clobber the stockholders."

Mr. **White**. Senator, you have been involved in a lot of conversations with the press. I have heard him make more complete statements where he says that is one of the things that is being studied, but there certainly has been no decision that we will build another powerplant there at this time.

Senator **Bumpers**. Well, our legislation would help him keep his word, so at least from that standpoint it ought to pass, do you agree?

Mr. **White**. Senator, as you know, we oppose this. You look at future powerplants, but one of the major defects of S. 1149 is that it applies to Grand Gulf I and Grand Gulf II. The approvals that are required by this bill would have had to have been obtained in

1973, and we have no way to go back to that point in time and do now what we failed to do back then.

This is a very unfortunate mess. One of the witnesses that preceded me said that if Middle South had to do it all over again, he is not sure that they would have done it exactly this way. I think we can agree that we regret very much the controversy, and we do not think that we have gained quite a lot from the controversy. We would like to see things resolved on the front end, but this bill does have some problems.

As you know, the State of Arkansas as well as the other jurisdictions have passed laws calling for approval at the front end, and we are complying with those.

Senator BUMPERS. You are familiar with the tax reform bill as far as the Senate version is concerned, are you not?

Mr. WHITE. Yes.

Senator BUMPERS. It does a great big favor for Middle South.

Mr. WHITE. No; it does not.

Senator BUMPERS. $700 million. Here is Senator Pryor, who's on Finance. Is it not $700 million?

Senator PRYOR. Are we talking about the investment tax?

Senator BUMPERS. Yes; the investment tax credit.

Mr. WHITE. Middle South Utilities has $700 million investment tax credit carryforwards accumulated to date.

Senator BUMPERS. If that bill goes through that way, George, can the Middle South consumers assume that this amount will go right out of the rate base, and that Middle South's customers will get the full benefit of that $700 million?

Mr. WHITE. Whatever investment tax credit carryforwards we are able to use, when we use them, the credits that we use will be amortized over the life of the plant or the equipment that gave rise to those carryforwards, and the customers will get the benefit of the entire amount of the carryforwards that is used.

Perhaps Chairman Bradford may be familiar with the ratemaking treatment of ITC carryforwards in Maine and might be able to confirm that, but that is my understanding.

Mr. BRADFORD. Whatever they are in Maine, I would not want to venture to say that they would be the same. My preference would be to be able to flow them through directly to ratepayers, but of course Federal law precludes that by saying that any State commission that flows through, pays utility tax benefits directly to ratepayers, the utility then loses the tax benefit. So the State commission hands are largely tied in terms of what seems to me to be the best treatment of both investment tax credits and the accelerated depreciation allowance.

Senator BUMPERS. On ANO I and II, George, I was Governor when the certificate for ANO II was granted them by the public service commission. I may have been Governor when the ANO I permit was granted. I am not sure.

Do you know who signed their name for the construction of those two plants? They were given permission by the Arkansas Public Service Commission to build those two plants, and the bonds were issued by Arkansas Power & Light. Arkansas Power & Light was planning for our future and, as I said earlier, they did a good job of it.

Now, the fact that we sell power from them to other people and we get $4 million a month for it, that is all well and good, and that was a company arrangement. If that had gone before FERC, FERC would have had the authority to mix it up, change it up any way they wanted to.

They have thus far turned out well, ANO I and II. It is the cheapest power, I guess, that the whole system generates.

Mr. WHITE. That is one of the things that was a controversy in the FERC proceeding. The FERC found that the way you described the situation was not the way it happened, but that those units were planned by the entire system. The system had been planned as a single integrated utility.

Senator BUMPERS. You suggest that could not happen under my bill, and I suggest that it could. Even if Middle South had decided to build that through MSE, under my bill they would have had to go to each of the public service commissions and say we are planning to build these two nuclear plants in Arkansas, and here is the way we are going to finance it, and here is the way we are going to sell the power.

Mr. WHITE. I do not think we could have foreseen in 1970 or 1973 the circumstances in 1980, 1983, or 1986 and the approvals.

Senator BUMPERS. Well, you obviously could not foresee by building Grand Gulf I and II what was going to happen.

Mr. WHITE. We have gone through a tremendous period of change and upset in the energy markets that has made this committee very busy in the last couple of years.

We have gone through periods of the Fuel Use Act where we had to plan for completely getting off of oil and gas by the end of this decade, just 3 years from right now. We would have had to have been completely off of oil and gas. When you were Governor of Arkansas, there was not a kilowatthour on the Middle South utility system anywhere that was generated by anything but oil and gas.

So we have done a tremendous job in the last decade of diversifying our fuel supply by building these coal and nuclear plants. It has been tough. That is why we have a little bit more capacity margin.

Senator BUMPERS. A little bit more?

Mr. WHITE. We have about a 33 percent capacity margin, which is not nearly as high as——

Senator BUMPERS. How much more?

Mr. WHITE. About a 33 percent capacity margin for the system.

Senator BUMPERS. Mississippi alone has 100 percent excess capacity. Arkansas has 65-percent excess capacity. How on Earth do you get to 30 percent capacity for the system?

Mr. WHITE. I do not understand your figures.

Senator BUMPERS. I think that Peter Bradford will verify this. Nationally, we consider about a 15- to 20-percent reserve capacity adequate.

Mr. WHITE. We consider about 20 to 25 percent, and I have our experts here. Our capacity margin is 33.

Senator BUMPERS. I would not even object to 30, but in Arkansas right now as a result of Grand Gulf, we have a 65-percent excess capacity. Mississippi, the poorest State in the Nation, has 100-percent excess capacity. They are paying for twice as much power as they can use, George.

Mr. WHITE. With 2½-percent load growth per year Arkansas, without Grand Gulf, would need a new powerplant in the early 1990's. The entire Middle South system would need that with normal load growth in the 1990's. We are not starting anything like that now.

Senator BUMPERS. Do you think Grand Gulf was a good decision.

Mr. WHITE. Remember that that plant is going to be in operation 40 years from now. That is the year 2030. We will be tearing that one down, and who knows? The life of it may be extended.

Senator BUMPERS. So is Waterford, and Independence, and Pine Bluff.

Mr. WHITE. What will happen over the next 20 or 40 years to the price of oil and gas? What will happen in the environmental laws? I cannot answer that, but I think over time it will prove to be of benefit.

I will tell you this. When you average that with all the other decisions we have made, we come out as a pretty competitive system.

Senator BUMPERS. Have you seen this headline in the Arkansas Democrat? "Electric Rates In Little Rock Near The Top."

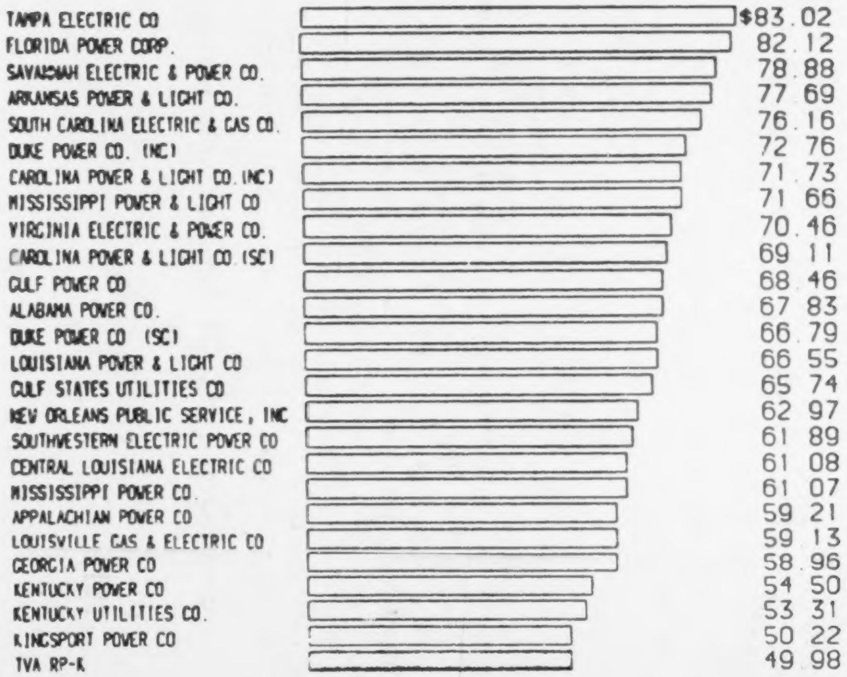
Mr. WHITE. We dispute those figures.

Senator BUMPERS. Well, you did not. It says that AP&L had no comment to make on it.

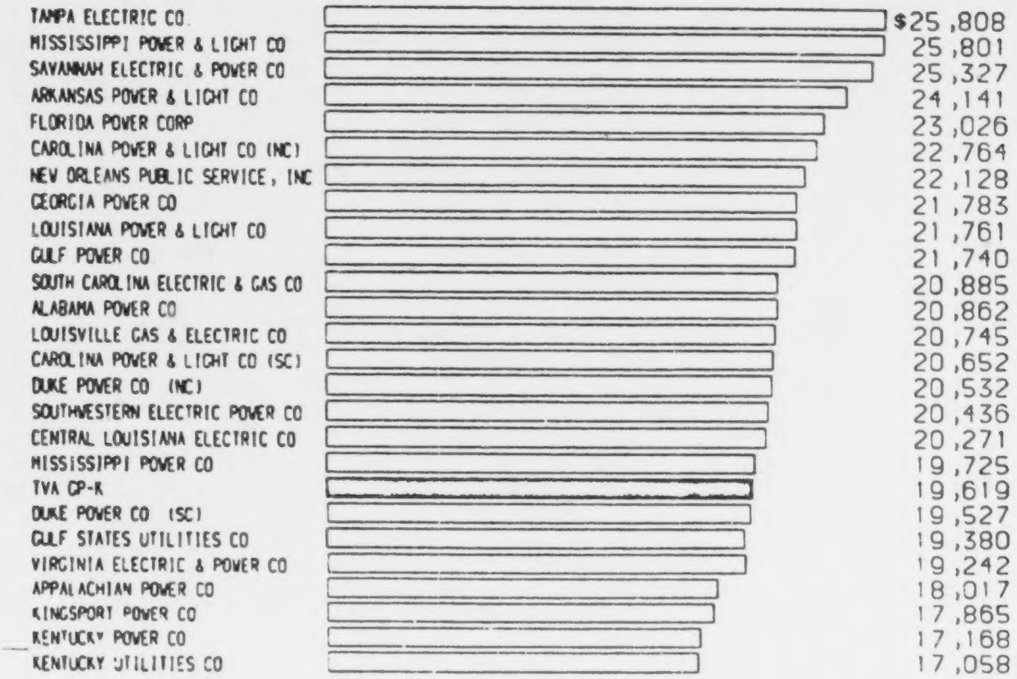
Mr. WHITE. We dispute those figures. They are there for everybody to see. The Energy Information Administration of DOE computes average bills on a comparison basis. Everybody can compare it. It is not something to hide. We just do not think that is accurate.

[The numbers referred to by Senator Bumpers follow:]

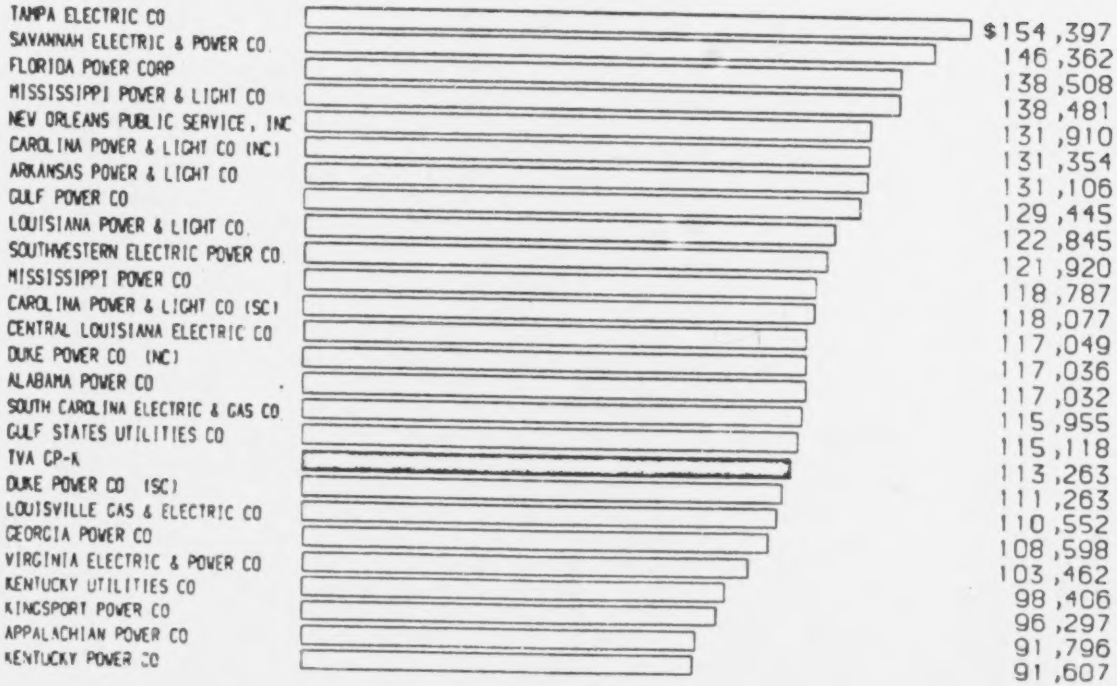
APRIL 1986
COMPARISON OF RESIDENTIAL POWER COSTS
TVA AND UTILITIES IN THE SOUTHEASTERN U.S
1,000 KWH



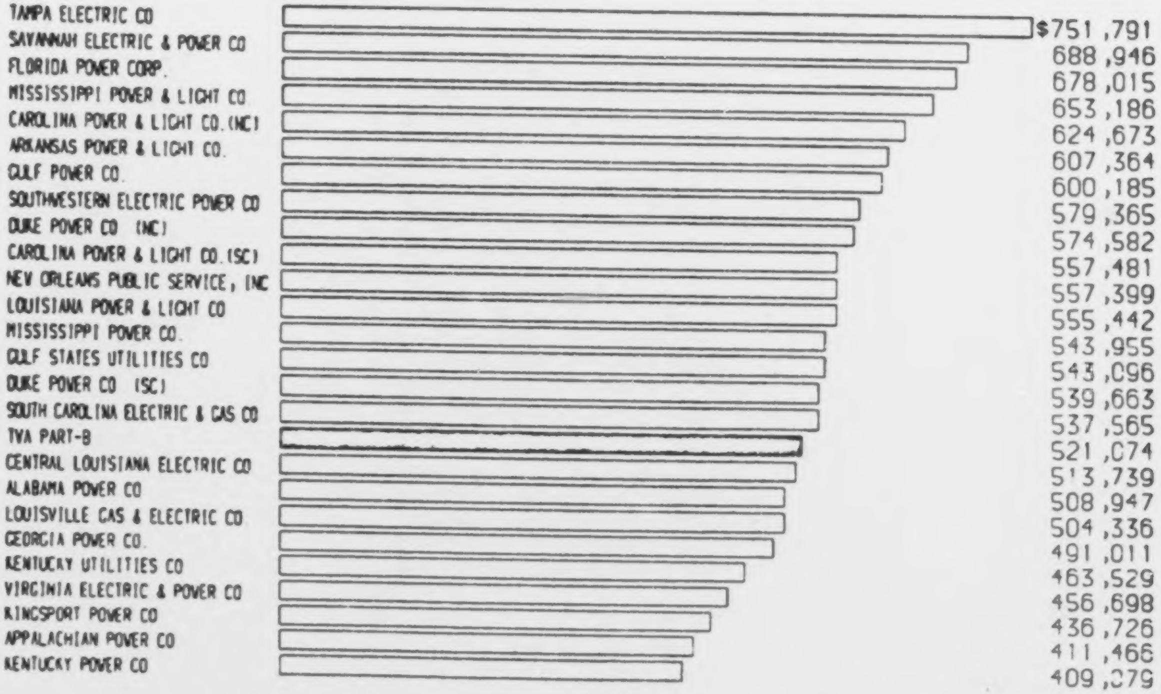
APRIL 1986
COMPARISON OF INDUSTRIAL POWER COSTS
TVA AND UTILITIES IN THE SOUTHEASTERN U S
1,000 KW AND 400,000 KWH



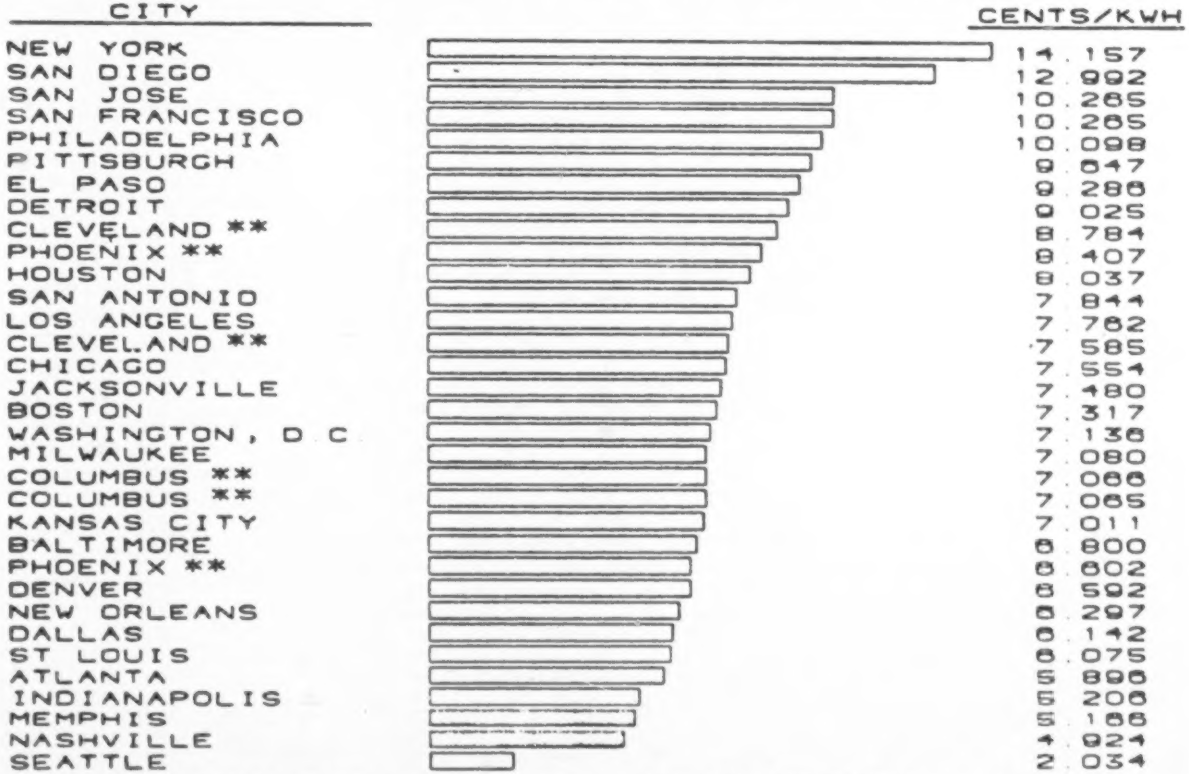
APRIL 1986
COMPARISON OF INDUSTRIAL POWER COSTS
TVA AND UTILITIES IN THE SOUTHEASTERN U S
5,000 KW AND 2,555,000 KWH



APRIL 1986
COMPARISON OF INDUSTRIAL POWER COSTS
TVA PART-B AND UTILITIES IN THE SOUTHEASTERN U S
20,000 KW AND 13,140,000 KWH



RESIDENTIAL PRICE PER KWH OF 1,000 KWH OF ELECTRICITY IN THE 30 LARGEST U.S CITIES*-APRIL 1, 1986



* DETERMINATION OF 30 LARGEST CITIES BASED ON 1980 CENSUS

** CLEVELAND, COLUMBUS, AND PHOENIX ARE SERVED BY TWO POWER SYSTEMS.

Senator **Bumpers**. Mr. Dowd, how do you account for the exponential increase in the amount of power in this country under the jurisdiction of FERC? It is twice what it was about 6 years ago, as I understand it.

Mr. **Dowd**. It seems to me that this relates to the fact that the demand forecast made in the early 1970's proved not to be warranted. It is hard for me to lay this at the doorstep of FERC any more than at the——

Senator **Bumpers**. I would not lay it at the doorstep of FERC. I would lay it at the doorstep of the utility companies, all of whom are fighting to get to FERC and avoid local regulations.

Mr. **Dowd**. Let us look at the utility companies. They based their forecasts on the best information available to them in the early 1970's. Economic forecasts were in line with the forecasts made by Government economists. They were in line with the forecasts made by the economists of financial institutions.

Then the world changed. The world out there changed on us. That, in very large part, is what happened.

Senator **Bumpers**. Let us take Peter Bradford, chairman of the Public Service Commission in Maine. He is the chairman of the regulatory authority in Maine, and he is obligated to the 1 million or 1½ million people in Maine and the consumers to protect them.

How can he fulfill that responsibility when he has absolutely no say-so over what power is going to be generated, what plants are going to be built, or what they are going to cost? FERC sets them, and the *Narrangansett* decision says he will pass them on.

Mr. **Dowd**. Mr. Bradford, like the rest of us, functions within a Federal system. We work within a Federal system, and we have an interstate commerce clause in our Constitution, so there has to be give and take.

Now, I am not familiar with the details of regulation in Maine. It seems to me that if a State wants to pass a law to regulate the construction of new facilities, it is certainly desirable to do so. We on the AEP system have no problem with that. We supported legislation recently in the State of Indiana whereby there would be preconstruction review of new generating capacity with an annual review.

Senator **Bumpers**. Why would you object to this bill, then?

Mr. **Dowd**. Because we are a multi-State system, Senator. We operate in seven States. We designed our system as a single entity, and this results in enormous efficiencies.

Now, quite frankly, there is no way of getting seven States to agree on anything, and this has been our experience.

Senator **Bumpers**. Is that all bad? Is that all bad because you cannot get all the States to agree? Do you think they have no say-so just because they cannot agree?

Mr. **Dowd**. No; I think it is bad if it prevents the integrated system functioning in interstate commerce across State lines from achieving these economies.

We just lost another big, industrial customer in our service area the other day to chapter XI. Now, these are energy-intensive industries in the upper Ohio River Valley. A number of them have gone the same way in the past year and a half. We have low rates. The low rates result from the economies that we have been able to achieve by designing a multi-State system.

What I am suggesting is this, Senator. The State commissions can intervene as a right before the Federal Energy Regulatory Commission in matters that involve their States. They can come in there. They can present their point of view. They can battle it out amongst themselves, so we have to have one decisionmaker where a number of States are involved.

Let me give you an example on our system. We recently revised our transmission agreement to reallocate the cost of this transmission agreement. Some companies within our system wind up paying money and some receiving money. All right, but FERC is going to make that decision. The State commissions come in and argue their points of view.

The Kentucky commission, which winds up being a recipient of payments under this new proposal, does not want a particular provision. We have tried to cushion this by phasing the impact of these payments in over a 5-year period. Kentucky, which benefits under this new proposal, says we want to get it all the very first year. We do not like phase-in. On the other hand, the States with our companies that make payments are arguing that they do not like this approach at all.

We find that it is very, very difficult on a cooperative basis to go to six or seven State jurisdictions and to resolve these issues on a voluntary basis. We feel we have to go before a Federal agency, let the States have their say, and let one agency make a decision that is subject to appeal to the Federal court. That is the only way we can see if the multi-State system is to survive in this country.

Senator **Bumpers**. You know, Mr. Dowd, the reason the Democrats are the minority right now is because of that very philosophy, and that is that the old Federal Government knows best.

Mr. **Dowd**. It is not a question of the Federal Government knowing best. It is a question of five States fighting amongst themselves, each wanting to maximize the interests of their own constituents, understandably, deadlocked unless there is somebody up there that can make a relatively impartial decision for them and make it stick.

Senator **Bumpers**. Why not go to the States? If you have seven States and four of them agree to the capacity, then build that capacity. If three of them do not want the capacity, why should they have to pay for it? No responsible State official would let it happen, but why is that not their prerogative, and we are also talking about responsibility, to let the lights go out if they want to?

Mr. **Dowd**. Senator, remember, this is the real world.

Senator **Bumpers**. That is the prerogative of the people. State regulators are subject to the will of the people. They are either elected or the Governor appoints them.

Mr. **Dowd**. They are gone in 2 years, those people, and then we are faced with a blackout in a particular State. You know who is going to be held responsible for that as well as I do. The public utility and its management will be held responsible.

Senator **Bumpers**. I think I would rather see that than to see the kind of paternalism that the utilities feel that they have to exercise by bypassing any input from the various States, I must say.

Mr. Dowd. If the States can come into the FERC and argue their case, it seems to me that they do have inputs.

Senator Bumpers. We went before the FERC and argued our case until the cows came home, and you see what we got for it.

Mr. White. Senator, I do not think that if a situation like Grand Gulf were to arise again and a State PUC were to object from the beginning, whether this law was in place or not, whether they——

Senator Bumpers. George, how could they object when they did not even know about it? They did not even know about it.

Mr. White. This was quite public, and maybe they were not following our filings with the Federal Government in the formation of Middle South Energy and the approvals from the Securities Exchange Commission.

We had had a system agreement in place for many, many years, and it always had been approved by the Federal Power Commission back then. We said that this would be a part of the system agreement.

Senator Bumpers. That system agreement, though, was totally ignored in the FERC decision.

Mr. White. We could say back then they should have realized what was happening, and we should have realized what was happening. Everybody expected this to be such a cheap plant, and to be shared among everybody it was going to be cheaper than all the rest of them. Nobody thought it was a big deal.

But now that we have gone through this, if a company builds a powerplant in the same circumstances and the PUC objects tremendously, I am sure that FERC will take that into their consideration.

Senator Bumpers. George, every single agreement that was made by the subsidiaries of Middle South pertaining to Grand Gulf in effect was summarily discarded by FERC. You tell me one agreement that was not. The memorandum of understanding of 1980, the systemwide agreement of 1973, the agreement of 1974, you tell me which one of those FERC allowed to stand. They threw every one of them in the wastebasket and said here is what we are going to do with Grand Gulf.

Mr. White. You are right. The 1973 system agreement was very unworkable. The concepts that worked back then when powerplants were very cheap would not work where the costs are large. The cost swings that would have been imposed upon the individual companies each year would have been enormous and unburdensome, so that was just not operative. That is why the change came about.

Senator Bumpers. Mr. Barr, you said 1 moment ago that the financial community had to have some certainty and some understanding, and I think you used the word friendly.

Mr. Barr. I do not believe I did.

Senator Bumpers. Well, you mentioned that the present FERC is quite a far cry from the FERC of the 1970's, and I certainly will agree with that.

If my bill passed, however, would that not make it rather irrelevant whether FERC was friendly or unfriendly?

Mr. Barr. I think, Mr. Chairman, to be clear on what I said before I answer your question, it is not that we view FERC as having changed so much but that the relative benchmarks, the comparative State regulations have, from an investor's standpoint, deteriorated fairly substantially as those tough decisions have come up over the last 5 or 10 years.

Senator **Bumpers**. Let me ask you this. Would Morgan Stanley finance a system built by Arkansas Power & Light that the Public Service Commission of Arkansas had approved? They had said we need the power, you are going to build it, you are going to build it in a site that has been approved, and you are going to have to go out there and raise $500 million to build it?

Now, it is a very clearcut, simple case. Would Morgan Stanley rather finance that, or would they rather finance one of a holding company which none of the public service commissions have approved, none of them even know it is about to take place, none of them have agreed they need the power, none of them have approved on the front end the cost? Which would Morgan Stanley's investors rather finance?

Mr. **Barr**. The former and not the latter. The problem is that, as I understand it, at the outset of Grand Gulf I the combined project would have been 1½ times the total balance sheet of the host company.

So I think what we are dealing with here is engineering trends over the last 20 years that have driven these so-called economies of scale to build plant sizes that are bigger than the ability of single utility balance sheets to build them.

Senator **Bumpers**. Now, if you are an analyst for Morgan Stanley, and MSE came to you and said, look, we are going to build this for Mississippi Power & Light because they are the ones that need the power but they cannot finance it, why would that not raise a red flag to you by saying if you are going to build this for Mississippi and they cannot finance it, maybe you do not need all this capacity?

Incidentally, is Morgan Stanley involved in the financing?

Mr. **Barr**. We were not involved in any way in the financing or establishment of MSE at the time it was done. In the last 3 years or so, we have been an adviser to the company during its dealings with the banks and other financial institutions. In fact, we have been an important underwriter of their securities, Mr. Chairman, but this is basically history that preceded our involvement with the company.

Senator **Bumpers**. Everybody owes FERC a big one.

Mr. **Barr**. I will try to remember your question so that I may answer it.

Senator **Bumpers**. Well, I was just asking——

Mr. **Barr**. I believe the question——

Senator **Bumpers**. Why would that not raise a red flag to you?

Mr. **Dowd**. Senator, may I interject on these financing mechanisms. The AEP system had to resort on two occasions to the creation of a new subsidiary for the purpose of financing a 2,600-megawatt coal plant, the Gavin plant, and our Cook nuclear plant.

Now, we did that because under the mortgages of the basic companies, there simply were not enough property additions available to support the issuance of bonds. We created a new subsidiary with a new mortgage.

The financial limitation had nothing to do with the need for that plant in terms of supplying power. Once the financing was completed, we collapsed the subsidiaries, and they are no longer in existence.

It seems to me that the financial limitations of a technical nature ought not to be necessarily regarded as totally red flags. Those plants are in operation. They are performing very well, and they have been for the last 10 or 15 years. They are low-cost producers, but we had to establish a separate subsidiary in each case to finance them.

Senator **Bumpers**. Mr. Barr, if I were financing Grand Gulf, and you told me that Mississippi needed the power but they could not finance it, I would ask who is going to pay for it? Who else is involved? You say Arkansas Power & Light, Louisiana Power & Light, and New Orleans Public Service.

Your next question is, have they gotten approval from their respective authorities to do this? If I were an investment analyst for Morgan Stanley, that would be the very first question I would ask.

Mr. **Barr**. If I may answer your question on a couple of points, I think that precommitment by appropriate regulatory jurisdictions can only help reduce investor uncertainty and worry about whether or not it is going to get paid for when it is done.

CWIP in the rate base would help, too. A little cash in rates along the way would avoid that rate shock of 40, 50, 70 percent on completed nuclear units where shareholders have been required to pay the entire freight for the 10 or 15-year period of construction.

I do want to answer your red flag question specifically, Mr. Chairman. I think that the use of project financing vehicles, special purpose paper shell companies, as you alluded to Middle South Energy earlier in these hearings, is a relatively established, honest, tried and true financing technique for any large projects not limited to the utility business.

If you look at other large natural resource projects where the companies that are building them have no regulatory strategy, they are not regulated projects. They are pipelines or tankers. The trans-Alaska pipeline system which brings the oil down from Valdez is a project that is based on a project-financing structure. That has helped us out with OPEC. It has put a lot of important domestic oil into the country. That was built with that same kind of structure.

So I do not think there is anything cruel or unusual about the establishment of Middle South Energy as a project-financing vehicle.

I think that the red flag question, if I understand that question, is really the question, should not investors think something is amiss if the future projected size of that plant is so much greater than its existing balance sheet? If it cannot raise the money on its own balance sheet, is there something wrong with it?

If that is the question——

Senator **Bumpers**. Let me clarify that, Mr. Barr. We will walk through this hypothetical case. If something is going to cost $1 billion, and Mississippi Power & Light can only use enough power to finance $500 million of it, your next question ought to be are you going to build this excess capacity anyway? If so, who is going to pay for it? We are not going to put up $1 billion when Mississippi can only pay for half of it. So your next question is who is going to pay for the other half of this power?

If they say, well, AP&L is, then your next question is do they have the authority to build? It ought to be. Morgan Stanley needs me.

Mr. **Barr**. Indeed, we do. I think a total market for the power certainly would be an important component. Unfortunately, the kinds of things that both investors, company managements, and regulators had to deal with 15 years ago before they knew as much about nuclear as they do today is that they went with forecasts. Those forecasts involved high growth in the States that you gentlemen represent as well as elsewhere in the country. Those things changed. The energy picture changed.

I do want to say, as a last point, that the use of Middle South Energy as a financing vehicle really is consistent with companies as big as Exxon that could do any project they wanted with their own balance sheet. The reason they use things like project financing vehicles is because of the particular nature of the project, where you can use more debt, less equity, and a lower cost of capital. So for financial reasons, not regulatory reasons, people use these kinds of things.

Senator **Bumpers**. Senator Pryor, you have been very patient, and I apologize.

Senator **Pryor**. I want to thank you, Senator Bumpers, for letting me participate here today. I have just one or two quick things. Everyone is tired, we have beat this issue to death, and it is 6:40 p.m.

I was just sitting here thinking about all this. Would we need FERC if we did not have multi-State holding companies, energy companies?

Mr. **Dowd**. I think you would, Senator.

Senator **Pryor**. You look at it as sort of a referee between the States? If you are like Mr. Bradford and just have Maine, and I assume that is just Maine.

Mr. **Bradford**. We are part of the New England Power Pool.

The power pools would raise some questions that go across State lines. If you had regional regulatory compacts that encompassed the power pools, then in large part you would not need FERC, at least not for electricity.

Senator **Pryor**. Years ago, I remember when a good friend of mine went on the board of Middle South Utilities, and I frankly do not know if he is still on there. I kind of hope he is not, because it has not been very pleasant, George, to defend this case for a long time, I know.

I remember I told him when he went on the board, I said I want to congratulate you for going on this board, but philosophically I do not believe in our State's utility being owned by anyone else, having reference to the Middle South ownership of Arkansas Power & Light as far as a philosophical thing.

The only thing I want to mention here, I may have been a little wrong in an earlier statement I made to the committee. I forget what percentage I said had been completed in Grand Gulf II.

What is that percentage, George?

Mr. **White**. It is about one-third.

Senator **Pryor**. About one-third? I think I said about 80 percent.

Mr. **White**. Grand Gulf II is only about one-third completed.

Senator **Pryor**. I wanted to get the record corrected.

Now, Senator Bumpers asked about Grand Gulf II. When do you think we will be able to know something about what the future and what the potential is for the Arkansas ratepayers as it relates to Grand Gulf II?

Mr. **White**. Well, they are trying to reach a decision by the end of the year.

Senator **Pryor**. All right, you said that about a 12-percent increase by the 11th year of Grand Gulf——

Mr. **White**. That is right.

Senator **Pryor** [continuing]. Would be, I guess, added on to the cost of electric bills due to Grand Gulf I.

Mr. **White**. That is right.

Senator **Pryor**. Now, that is 12 percent of the overall bill. In other words, I can only assume that Arkansas Power & Light will be going in the next 11 years to the local public service commission to seek additional rates.

Mr. **White**. It would.

Senator **Pryor**. So let us say if you have a $100 a month utility bill now, in 11 years from now that is going up because of other rate increases, let us say that is $200. Still, by the 11th year you are going to be looking at 12 percent of that bill each month that is still going to be added on there for Grand Gulf I. We are talking about 12 percent a year or a month, is that correct?

Mr. **White**. A 12-percent increase.

Senator **Pryor**. How long will that have to be a part of that utility bill? How long will it be before the ratepayers finally pay this thing off?

Mr. **White**. Senator, it has a design life of 40 years, and we expect it to be producing power for that period of time.

Senator **Pryor**. So even though we are not using that power——

Mr. **White**. You are using that power, Senator. The 36 percent Grand Gulf allocation to Arkansas is certainly going to Arkansas.

Senator **Pryor**. That is 36 percent of the cost. We are not getting any of the power.

Mr. **White**. Thirty-six percent of the power, also. Now, they may turn around and resell energy into the pool, but they are getting the electricity that goes with the cost.

Senator **Pryor**. Well, we have the potential of getting 36 percent if we need it, is that correct? We are not using it, and we are still paying for it.

Mr. **White**. Whether the kilowatts actually flow is Kirchhoff's Law, but the kilowatt hours the Arkansas Power & Light Co. is paying for is going to Arkansas Power & Light Co. Now I say if they have more than they can use from what they produce plus what they are getting from Grand Gulf, the excess may go into the pool to be resold or split up among the other companies, but they are certainly getting the kilowatt hours associated with what they pay for.

Senator **Pryor**. We will maybe talk about that on another day, but I still do not quite understand that part of it.

I learned a great deal today from all of the witnesses. I appreciate you all coming, and I speak for myself when I say that.

Senator Bumpers and I represent a very, very frustrated constituency out there about what has happened in this Grand Gulf fiasco. I think that is what Mr. Bradford called it, a fiasco, and that is what we think it has been, and that is what they think it has been.

Hopefully, this hearing will bear some fruit, and hopefully the committee, and ultimately the Senate and the House, will look favorably upon this legislation which Senator Bumpers and I have introduced to help bring back historic perspective and involvement in the setting of electric utility rates for the local public service commissions throughout the States.

Thank you.

Senator **Bumpers**. Peter, you had a comment you wanted to make a while ago, and I am sorry I did not get back to you.

Mr. **Bradford**. I have been sitting here feeling rather like Alice in Wonderland for the last 20 minutes or so, listening to the gentleman on my right. I really think that they see a reality that is almost 180 degrees different from the way that I see it, both with respect to this legislation and with respect to utility regulation in general.

Let me just touch on the fundamental differences. There seems to be almost a notion that when the Federal system as we have it and the needs of utility holding companies—with which we are not familiar in Maine, so I have not come across this attitude before—collide, it is the Federal system that must give way and not the needs of the utility holding companies.

Somehow, if projects, and you put your finger on this as well, are beyond the needs of individual States, we need some entity that will assure that the neighboring States and the holding companies somehow pick up a piece of it, necessary or not, regardless of what State regulators may think of the needs within their State.

Mr. Barr said that he thought that the State regulatory climate had deteriorated in recent years. That statement, by any measure, is preposterous. The State commissions are better funded. They have more expertise. The commissioners themselves are better qualified than their counterparts of a decade or two decades ago. They are infinitely more sophisticated on these problems now than they were then.

Let me be kinder than suggesting that this statement is preposterous and suggest to you that it is a form of a code. What it really is a cover for is the fact that in the last 5 to 10 years, State utility commission decisions have pointed out the ways in which utility management shortcomings and, in fact, the shortcomings of the analytical process that Wall Street applied in financing these utility projects have gotten the country and its ratepayers into a great deal of trouble.

The fact is that investment bankers and commercial bankers with regard to utility projects have not historically examined the marketplace in the way that they would for a paper mill, an oil refinery, an automobile plant, and asked whether the product could be sold at the prices that would have to be charged in order to recover the cost.

It is all very well to say that the world has changed in the last decade. Of course it has, but those changes did not come overnight, and the fact is that investment analysts just did not apply the level of sophistication to this business that it did to some others. They are now confronted with some very embarrassing results that they have to explain to their clients.

To them, the phrase "regulatory climate has deteriorated" means that regulators are second guessing in a way that they never used to, and this is a very convenient ally. The truth is, however, that the process has been quite rotten in its analytical shortcomings. Morgan Stanley and Wall Street certainly share in that in their failures to assess the marketplace for kilowatt hours for Grand Gulf and the other very expensive plants around the country.

As I say, the investment process works very differently on industries, at least historically, that are in a competitive environment than those such as utilities. That has to change, and it will not change if the solution seems to these gentlemen to be to point the finger at regulators.

Lastly, your legislation, it seems to me, remedies some of the shortcomings of the existing process in precisely the opposite manner that has been suggested; that is, by making available the possibility of State prudency analyses in a FERC-regulated transaction if the State has not also approved it.

The real effect of that will be to assure the kinds of prior approvals that reduce risk, that grant greater certainty, and you have pointed that out, certainly, on several occasions as well.

We, on a prior approval basis, now, deal with almost all of the capacity additions among the Maine utilities. There is no necessary aversion in State regulation to doing that, and I think your bill in that respect will fill a very useful void by giving utilities, as they confront what legislation they would like to see introduced in their States in the future, a real incentive to be sure that in fact the State commission is in a position to sign on to major capacity additions not only in the year that it is first brought into being but also, if those commissions have any sense, in some continuing review process which requires major changes in either demand estimates or cost estimates to be incorporated in those reviews.

So, in the long run, your legislation will make the process more certain, not less certain.

Senator **Bumpers**. Peter, I appreciate that statement. I will let Mr. Barr respond to what is preposterous and what is not.

Mr. **Barr**. If I may, Mr. Chairman, the word deterioration was not loosely used on my part. What I had in mind was the various rating agency services that officially rank on an ongoing basis the State and FERC regulatory jurisdictions from an investor standpoint, which I hope I was clear in saying earlier.

Clearly, what is good for the goose may not be good for the gander, but from an investor viewpoint there is a clear deterioration. The evidence of that would be that, whereas a few years ago a large number of States were rated No. 1, which would be the top tier, an example of which would be Duff & Phelps which has six rankings from one to six, currently there are none, including

FERC. There are no regulatory jurisdictions in the country that are rated as high as one.

So the word deterioration is a specific use, but that is a question of format. Let me really respond to the substance of Mr. Bradford's comments.

If in fact investors and analysts had used the kind of farther-reaching analysis that he suggests and had reached different conclusions regarding the ultimate market for power and the risks associated with bringing plants on line at the projected cost, then in fact they would have required higher returns.

The cost of capital would have gone up, and the cost of those plants would have gone up as well. So the ultimate cost to the ratepayers, had those plants gone ahead, would have been to result in a higher cost of capital on the plants that were built.

So I think the market is efficient, and I think there has been deterioration. I do not wish to cast dispersions on the quality, the analytical quality or the judgmental quality of the regulatory bodies in the country, but I am making a specific point about how it looks from the investor's standpoint.

Mr. **Bradford**. You see, that point is actually absolutely wrong. This is the Alice in Wonderland problem, again. The kinds of regulation that were rated the highest, that are perhaps still rated highest on those silly charts that are put out that purport to rate the State commissions, are the ones that were most lenient toward letting utilities get into this kind of trouble.

New Hampshire was rated high. Maine was rated low 10 years ago. Indiana was rated high. Other States, more skeptical States, California say, were rated low. You can go right across the country and do that. In many of the States rated highest on these charts 5 and 10 years ago, you now have the problem nuclear plants precisely because those State commissions, through their leniency, through their willingness perhaps to allow a very generous equipment rate base, through their willingness to allow the utilities to do what they want, encourage those utilities to get into this kind of trouble.

Two examples are the regulators in Wisconsin and in California went a long way toward keeping their utilities out of it. Even if you look at it from the very investor perspective that you purport to espouse, if you look back at the record of those charts that you are using as a yardstick, for the last 10 years you will see that it has produced very bad results.

An investor who invested $10,000 in several of the States rated highest on those charts 5 to 10 years ago would probably have done much worse than one who had put the same $10,000 in many of the States rated at the middle and at the low end. It is not an absolute flip-flop, but it is darn close. The reason is that many of the criteria used to judge which States deserve the high rating was the leniency of those States toward utilities that were headed for serious trouble.

Mr. **Barr**. Not to prolong the discussion, but I would argue it is more complicated than that; that in cases like the State of Wisconsin, it was not the brilliance of the regulatory commissioners, although I respect those individuals, that resulted in their high rankings. It was rather that it was a low growth State, the plant was not required, and the utilities, the three Wisconsin electric companies, because they had no active construction programs, had very strong cash flow, improving credit ratios, and the investors decided they liked this.

Mr. **Bradford**. The reason they didn't like the construction programs were that the utilities ordered them out of the nuclear projects.

Mr. **Barr**. Also because it's a no growth State, because business is leaving Wisconsin.

Mr. **Bradford**. We are talking, now, about the period 1974 through 1977.

Mr. **Barr**. I am talking about today.

Mr. **Bradford**. Yes, but the point of time at which the Commission took the utilities out of the nuclear construction program that would otherwise have gotten them into the same kind of trouble that many of the surrounding States did was the mid-1970s, as the result of which Wisconsin was rated relatively low and New Hampshire was rated relatively high. They were much better off putting the $10,000 in Wisconsin.

Mr. **Barr**. The managements of the companies in the State of Wisconsin, I believe, would not give a lot of credit for the decision not to build to the State regulators.

Mr. **Bradford**. That may be, but they are now hiring two of the three regulators as consultants on a regular basis.

Mr. **Barr**. Does that include Northern States Power?

Senator **Bumpers**. All good things must come to an end. I have enjoyed all I can stand of this. I want to thank all of this panel for your very thoughtful comments and for being here. These sections, I hope, will prove to be very helpful to this committee.

If I were a utility company as part of a holding company, I would be very much opposed to S. 1149, and if I were a poor ratepayer in Arkansas I would be very hot for it, and the ratepayer happens to be who I represent. So I have to push very hard for the passage of this legislation.

I do want to thank all of you. Each articulates the position from which he speaks extremely well, and I want to thank all of you for the time you have taken to come and be with us today.

Thank you. The hearing is adjourned.

[Whereupon, at 6:55 p.m. the hearing was adjourned.]

APPENDIX

Additional Statements Submitted for the Record

STATEMENT OF
OCCIDENTAL CHEMICAL CORPORATION
ON S. 1149
BEFORE THE SUBCOMMITTEE ON WATER & POWER
ENERGY AND NATURAL RESOURCES COMMITTEE
UNITED STATES SENATE

This statement is submitted by Occidental Chemical Corporation (OCC) in opposition to S. 1149, the "Ratepayer Protection Act of 1985."

OCC is a member of the class most directly affected by this proposed legislation -- the ratepayers which ultimately pay the costs of and depend on the service provided by the operating companies of a public utility holding company system.

OCC owns and operates a major plant in Taft, Louisiana which is served by Louisiana Power & Light (LP&L), a wholly-owned operating subsidiary of Middle South Utilities, Inc. When operated at full capacity, the Taft plant is one of the six largest chlorine plants in the country and is one of the two largest industrial customers of LP&L. The plant produces a number of bulk chemical products (including chlorine and caustic soda) for which the cost and availability of electricity is of critical importance.

Despite its status as a ratepayer whom the proposed legislation is allegedly designed to protect, OCC respectfully submits that S. 1149 is not in the public interest. S. 1149 would amend the Federal Power Act to permit a state utility commission which had not approved the construction of a generating facility by an operating company of a public utility holding company to make a determination independently as to the extent to which, if any, the costs of that facility could be passed through to ratepayers under its jurisdiction, regardless of any determination made by the Federal Energy Regulatory Commission (FERC) under the Federal Power Act with respect to the rates to be charged for the capacity of or the energy from such a facility.

OCC believes that S. 1149 would have a major adverse impact on the operating efficiency and financial viability of public utility holding company systems, such as the Middle South system. Allowing each state in which the system operates independently to decide whether to pass through system costs which the FERC has found to be reasonable would frustrate an integrated operation of the system. The Middle South system, for example, plans and operates its generation capacity on a coordinated basis as a single integrated system. All generation additions are planned on a systemwide basis to meet the needs of the system as a whole. This integrated operation is intended to provide planning, construction, and operational efficiencies on a regional basis that could not be as effectively achieved by individual operating companies.

However, such integrated operation requires a corresponding equitable sharing of costs and benefits on a regional basis. This approach best serves the public interest by providing for security of supply for the entire region while minimizing the impact on any one state's ratepayers of the financial hardships associated with any one generating unit. To preserve the benefits and share the burdens of regional planning and integrated operation, it is essential that the FERC fulfill the duties assigned to it under the Federal Power Act to determine just and reasonable rates for the exchange of capacity and energy among the operating companies of a holding company system. To leave to the state commissions the ultimate determination as to which costs will be recovered, at best, invites parochial decision-making and, at worst, threatens the continued viability of the particular utility system. While OCC strongly supports a careful review of the prudency of any costs incurred by a utility to provide service and seeks to obtain electric service at the lowest reasonable cost, it is also imperative that each operating company of an integrated utility system be allowed to pass through legitimate costs to its ratepayers to protect the system as a whole and, by extension, the ratepayers who are the customers of each of the system's member companies.

The recent Supreme Court decision in Nantahala Power and Light Co. v. Thornburg, 54 U.S.L.W. 4676, No.85-568 (U.S. June 17, 1986), reaffirms that, under the Federal Power Act, the FERC has exclusive jurisdiction over interstate wholesale rates and that a state must "give effect to Congress's desire to give FERC plenary authority over interstate wholesale rates. . . ."

Nantahala Power and Light Co., 54 U.S.L.W. at 4680. Contrary to this mandate, however, S. 1149 would give each state commission the opportunity selectively to veto the passthrough of costs determined to be just and reasonable by the FERC. This would effectively nullify FERC's jurisdictional authority to allocate fairly the costs of capacity and energy from generating units built to serve a region in a way that is equitable to all ratepayers in the region.

Supporters of S. 1149 argue that the FERC's decisions are limited to wholesale rates, and the proposed bill addresses retail rates. The simple fact is, however, that FERC's decisions regarding wholesale rates to be paid by utilities will be meaningless if the utility is unable, because of state regulation, to resell at retail rates that reasonably reimburse it for its costs. See Nantahala Power and Light Co., 54 U.S.L.W. at 4680.

S. 1149 is an attempt to upset the delicate balance between federal and state regulation under the Federal Power Act in order to permit the Arkansas Commission to undo a decision of the FERC with which it disagrees and the validity of which is currently pending judicial review before the U.S. Court of Appeals for the District of Columbia Circuit. The Committee and Congress should be reluctant to act to fundamentally change the Federal Power Act in order to alleviate the complaint of a disappointed litigant before the FERC in a particular case. Such an approach ignores the potential impact of the legislation in other situations and on other utility holding companies. In the Middle South case, the complex issues of cost allocation and cost responsibility within a utility holding company were resolved in an adjudicated setting where all the concerns raised by all affected parties were fully explored and litigated.

Moreover, the specific harm that prompted the introduction of S. 1149, the allocation of a portion of the costs of Middle South's Grand Gulf unit to Arkansas ratepayers, has, to a significant degree, been ameliorated since the introduction of the bill in May of 1985. Pursuant to a September 1985 settlement agreement approved by the Arkansas Commission, a substantial portion of the costs of the Grand Gulf unit allocated by the FERC to Arkansas Power & Light will be absorbed by Middle South stockholders and the recovery of a substantial portion of those costs will be deferred. OCC does not mean to minimize the dramatic impact of the costs of Middle South's construction program on all of the ratepayers on its system or of the adverse effects of substantial rate increases on all consumers, including OCC's operations in Louisiana. However, the Arkansas Commission's solution of attempting to avoid all cost responsibility for ratepayers in Arkansas is simply not a reasonable approach.

For the reasons stated above, Occidental Chemical Corporation opposes S. 1149 and urges this Subcommittee not to enact this bill.

Statement of Position on S.1149, the Ratepayer Protection Act

by the National Association of State Utility Consumer
Advocates and South Carolina Department of Consumer Affairs

Before the
Water and Power Subcommittee
Committee on Energy and Natural Resources
United States Senate

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July 23, 1986

INTRODUCTION

Thank you for providing us an opportunity to present our position on an important bill, S.1149 -- the Ratepayer Protection Act. The National Association of State Utility Consumer Advocates (NASUCA) is a national organization composed of officials in 35 states and the District of Columbia, who are directed by law to represent the interests of consumers of regulated public utility services before regulatory commissions. The South Carolina Department of Consumer Affairs ("Department") is an agency of the State of South Carolina and a member of NASUCA. The Consumer Advocate and Division of Consumer Advocacy within the Department have been created to protect the interests of consumers before regulatory agencies.

This Statement of Position on S.1149 primarily focuses on certain State preemption problems that would be resolved if it is enacted and on other practical, positive implications such a law would have for State regulators and electric utility ratepayers alike.

DISCUSSION

In the last few years, pressure has steadily mounted on State public utility commissions to throw in the collective towel and stop trying to regulate certain aspects of utilities' operations. The pressure has increased because the Federal Energy Regulatory Commission (FERC) and Federal Communications Commission (FCC) have "reinterpreted" their statutes in attempts to preempt authority of State regulators. NASUCA has consistently opposed such attempts by actively participating in such cases as the FCC's Computer II Inquiry, access charge case, and depreciation case and the FERC's Northern States Power Company coordinating agreement case and Phases I and II of its current Notice of Inquiry on Regulation of Electric Sales-For-Resale and Transmission Services. In each of these matters, as well as others, NASUCA has voiced the concern of utility consumers that State ratemaking authority should be maintained. Our view has prevailed in some of these cases but not in others. These cases illustrate the extent of the frontal attack on matters in the telecommunications and electric areas that have customarily been regulated by the States. S.1149 would, if enacted, contribute to sound regulatory policy in the electric area in several ways. Each is discussed below.

A. Clarification of Regulatory Boundaries

This act helps clarify regulatory boundaries between Federal and State jurisdictions in two major ways. First, by allowing a State commission to review and accept or reject FERC-approved cost allocations when that Commission had not previously approved the construction of the generating plant in question, it would modify the holding in the Narragansett case. Narragansett Electric Company v. Burke, 119 R.I. 599, 381 A.2d 1358 (1977). Second, it clearly applies only to cases involving the sale of power by one subsidiary of a public utility holding company to another subsidiary of the same holding company. Due to the jurisdictional confusion and inequity that presently exist, NASUCA believes this clarification is both helpful and necessary to ensure that a State regulatory commission will truly be able to establish rates on costs it -- and not FERC or other States' utility commissions -- deems appropriate for that State's ratepayers based upon the specific evidence presented.

NASUCA understands that there may be both winners and losers in situations such as the Grand Gulf Project. For that matter, NASUC has members from Arkansas, Mississippi, and Louisiana. NASUCA, however, still supports S.1149, because even though there may be eventual winners and losers in such projects at least the players will know the rules of the game.

B. Implications of Enactment of S.1149

Enactment of S.1149 would have several positive implications. There would be an incentive for the utility commission in the State where the new generating plant would be located to undertake an indepth prudency review of construction plans and the utility's broader approach to providing reliable and reasonably priced electricity for consumers. Such an incentive is overdue. Ratepayers, especially, are sensitive to the need for provision of electric service based on a review of generation projects before dollars are spent. For example, they typically may not be able to pass through to someone else their increased electric utility rates. This seems especially onerous to consumers when those higher rates are based in part on payment for a generating plant that is abandoned after millions of dollars have already been spent.

Furthermore, it would discourage holding companies from undertaking corporate reorganizations in order to circumvent State regulation in hopes of more lenient treatment at the Federal level. NASUCA remains unconvinced that the so-called "greater flexibility" arguments utilities make to justify reorganizing into holding companies bear serious consideration, since quite often the proposed activities could be undertaken within the utility's present organizational structure.

Finally, the bill would allow for review of a plant's costs after construction by State commissions that previously had not had the opportunity to rule on the legitimacy of such costs. Allowing these commissions this opportunity is better than the current situation whereby a State may have no choice but to pass through all costs in retail rates. However, if S.1149 is enacted, State legislatures would also enact new laws to implement this new (or restored) authority for State commissions. These laws hopefully would encourage coordination of least-cost planning among states to minimize the risk of rejection of construction costs already incurred by a utility.

CONCLUSION

S.1149, as drafted, promotes sound and reasonable electric regulatory policy at the Federal and State levels, and NASUCA endorses it. In addition, however, there are amendments to it that the Subcommittee may wish to consider to strengthen it.

First, the Subcommittee should consider an amendment to expand the act to protect States whose State commissions certificate a construction project based on representations of a utility company, and thereafter that company unilaterally attempts to depart from its representations to the detriment of the host State. This is the situation in Mississippi where the Grand Gulf Project was approved by the Commission based on a certain allocation methodology proposed by the Middle South Utility System and that holding company later requested a different allocation methodology from the FERC. Such an amendment would confer jurisdiction on host States to deal with such situations.

Second, the Subcommittee should consider broadening the bill's scope by giving State regulators the ability to review and modify any wholesale rate wherein the prudence or recovery of a generating unit's construction costs is at issue. It is unclear to NASUCA why State regulators confronted with such a situation should have their hands tied simply because the utilities involved are not sister affiliates of a holding company system.

Third, the Subcommittee should consider broadening the bill's scope for it to apply to transmission facilities apart from generating units.

Finally, the issue of passthrough of abandoned generating plant costs is a very important one both in terms of affecting electric rates of consumers and affecting the financial health and efficient management of utilities. In this regard, while the bill appears to authorize State examination of construction costs of operational generating plants, as well as abandoned generating plants, the bill would be strengthened in Section (2)(A)(i)(II) by explicit reference to "costs, including construction costs, related to any planned, operational, or abandoned generating unit" as well as to the "costs of production of electric energy from a generating unit."

STATEMENT OF N. M. NORTON, JR.
REGARDING S.1149,
BEFORE THE SUBCOMMITTEE ON WATER AND POWER OF THE COMMITTEE ON ENERGY AND NATURAL RESOURCES OF THE UNITED STATES SENATE

Mr. Chairman and Members of the Committee, I thank you for the opportunity to submit this statement regarding S.1149. In the course of the administrative and judicial proceedings surrounding the Grand Gulf project I have been privileged to serve as legal counsel to industrial customers of Arkansas Power & Light Company, the Middle South Utilities subsidiary serving much of the state of Arkansas. In various fora during that controversy I have appeared on behalf of industries such as Reynolds Metals, Weyerhaeuser, Riceland Foods, and industrial groups such as the Associated Industries of Arkansas and Arkansas Electric Energy Consumers. The latter group, AEEC, is a voluntary association of large or intensive industrial consumers of electricity formed specifically to intervene in regulatory proceedings to advocate cost-based electric rates. As you may expect, therefore, I have framed the following comments from the viewpoint of the industrial consumer of electricity.

The "regulatory climate" of a state directly affects not only utilities and investment bankers, but also the utilities' largest customers -- industrial electric consumers. Confidence, built through consistency and stability, in a state's regulatory climate can be an important factor in industrial plant location and expansion decisions when electricity is a major input.

The problem addressed by S.1149 in large measure concerns a conflict between state and federal regulatory jurisdiction. On the whole, industrial consumers generally prefer that electric utility regulation be divided along the "bright line" that the Federal Power Act has, at least until recently, traditionally been thought to draw between state and federal jurisdictions. On the state side of that line fall many of the more fundamental regulatory functions, including review of the investment in, and recovery of the cost of, generating facilities.

The Federal Energy Regulatory Commission's Grand Gulf decision dims the "bright line" to the point that it is indiscernible. The decision's potential as a precedent for other power pools has thrown the state and federal regulatory roles into confusion and has undermined the consistency and stability without which prudent and informed industrial decision-making cannot occur. Against the background of the Grand Gulf decision, state generating facilities siting decisions may or may not be final; power pooling contracts may or may not be enforceable; utility rights and obligations may or may not be reliable; and state jurisdiction may or may not be applicable, insofar as they all bear upon a customer's ability to forecast its electric input. In other words, FERC has in its Grand Gulf decision introduced a large and unnecessary element of uncertainty into a process that was previously thought to be well understood. From the standpoint of its impact on business decision-making, FERC's Grand Gulf decision is unsettling, to say the least.

FERC's decision is also surprising given the goals Congress embraced when it enacted the Federal Power Act ("Act") and the Public Utility Holding Company Act together in 1935. At that time, Congress was concerned that the states were sometimes incapable of meeting the regulatory challenge posed by sprawling multi-state utility holding companies. Congress believed that where the states could not or did not regulate power transactions, the Federal government should assert a concurrent form of oversight. In short, mutual, but not exclusive, regulation by both federal and state governments emerged as the key solution to the regulatory dilemma. Moreover, Congress strove through several critical provisions of the Holding Company Act to strengthen the efficacy of state regulation by reducing the scope and scale of multi-state holding company operations.

The resulting regulatory scheme did include several lines of jurisdictional demarcation. The federal government would assert control over certain wholesale interstate rates, while the state government would exercise control over retail and, (and in some cases, wholesale intrastate) rates. In an important feature of the Act, Congress chose to vest the states with exclusive authority over power generating facilities. Indeed, under §201(b) of the Act, the federal commission's jurisdiction was specifically withheld from generating facilities.

Despite Congress' intention, the Grand Gulf episode stands as an instructive example of how a utility may seek to frustrate state regulation -- so far successfully, I might add, though the matter is still under judicial review. When it conceived Grand Gulf, Middle South Utilities (MSU) realized that if it constructed the nuclear facility with each of its operating companies owning a share, then under §201(b) full state oversight would surround the project. This could have had the undesired consequence of triggering inquiries by all the affected state commissions into the costs and need for the stake in the plant taken by the MSU operating companies within their respective jurisdictions.

Notwithstanding the language of Section 201(b), the holding company observed that if a separate generating company were packaged in the form of a subsidiary to the multi-state holding company, it could apparently transform the true nature and purpose of the project so as to fall outside state regulation. By this means, MSU believed it could avoid the necessity of traditional, broad state regulation over the need for and costs of generating facilities. Certainly, too, a multitude of complicated questions regarding financing could likewise be circumvented, but that chapter of the story is not relevant here.

To implement this plan, Middle South took two closely-related steps. First, it simply established a separate MSU subsidiary -- Middle South Energy (MSE) -- that would hold legal title to the Grand Gulf plant. This way, on a hyper-technical basis, none of the operating subsidiaries would be directly owning or constructing the generating plant -- and therefore the ordinary nexus to state regulation would be severed. Second, MSU would have MSE sell the power at "wholesale" under inescapable, life-of-the-project contracts to each of the operating company subsidiaries so that, on paper, the power sales assumed the appearance of being subject to federal jurisdiction.

The subtlety and simplicity of the idea must be admired, however reluctantly. Middle South did not have to carry out any physical change in the manner in which the plant was constructed or in which the power was generated or transmitted. By simply inserting an additional corporate entity -- MSE -- into the transmission chain, MSU could argue that it had rendered nugatory the jurisdictional restrictions of §201(b) by transforming an otherwise retail sale of power into a network of wholesale transaction; thereby divesting the states of their authority to conduct any pre-construction (or post-construction) review of the decision to invest. Surely Congress did not intend for a paper transaction such as this one to deprive the states of their traditional regulatory authority.[1] Nevertheless, in pleading its case to FERC, Middle South Utilities has found a willing and eager listener.

The existing language of the Federal Power Act makes it amply clear that in such instances Congress has since 1935 advocated, if not required, a functional analysis that preserves the states' ability to review decisions to construct generating plants that would supply their citizens with power. Yet, as this Committee is well aware, FERC has rejected this interpretation and instead embraced a corporate fiction that obliterates the states' jurisdiction.

Such a corporate maneuver is not without historical analogue. Friendly transactions among related corporate entities and schemes designed to limit regulatory oversight or investor liability by pigeon-holing responsibility among a maze of corporate holes are just the sort of thing that led to passage of the Holding Company Act in the first place.

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[1] It is particularly noteworthy here that the Federal Power Act provides no comparable consumer protection -- pre-construction review of the decision to invest in new power generation facilities -- and FERC has traditionally demurred on the wisdom of post-construction contracts to take shares of power plants. Both matters have been left to the state commissions. But MSU has circumvented the former means of consumer protection and persuaded FERC to disregard the latter in the case of Grand Gulf, and other systems may be encouraged to follow in MSU's footsteps.

S.1149 offers Congress an opportunity to reaffirm its original intention. If enacted, S.1149 would send an unmistakable message to FERC and to the courts that the states do, in fact, have a significant role to play in reviewing decisions to construct generating plants that could impose monumental financial obligations on the states' ratepayers.

The theory implicit in the bill is that the reality of a transaction, rather than the way in which a corporation is organized, ought to be the critical factor for determining jurisdiction. In short, under S.1149 a functional analysis -- rather than regulatory surrender to the artifice of a paper transaction -- would determine whether a state has the authority to protect its citizens from the economic fallout of an unneeded yet highly expensive nuclear plant.

The mechanics and effect of S.1149 are not complex. The legislation would clarify that, when setting retail rates for an associate utility of a public utility holding company, a state may refuse to pass through all or part of a federally-approved rate pertaining to the transmission or sale of electric power allocated among the holding company's members. As drafted, the bill applies only where the state commission having regulatory authority over the associated utility has never approved the construction of the unit from which the electricity is generated.

Thus, the key thrust of the bill is to induce public utility holding companies (or other conceivable consortiums of utilities) to seek pre-construction review and approval by those states whose ratepayers would end up shouldering the cost of a planned generating plant. If such approval is obtained, then the "remedy" provided for in the bill -- disallowance of a pass-through to retail rates -- would no longer apply. Although the bill contemplates pre-construction review by the states, it is also entirely possible that post-construction approval under traditional regulatory standards would likewise discharge the utility's responsibilities.

S.1149 makes no explicit mention of its applicability to abandoned or "mothballed" plants, but the bill's language undoubtedly would apply. Indeed, to construe the legislation otherwise would frustrate what is perhaps the most vital of the bill's purposes. To the extent that the abandonment of a plant constitutes a recognition that the plant was not needed, overly expensive, or immediately obsolete, the obvious question is why the endeavor was pursued in the first place. It is in these situations that the pre-construction review by a state commission can have its most beneficial impact -- i.e. before the mistake is made.

From the standpoint of the Commerce and Supremacy clauses of the Constitution, S.1149 appears to pass muster. Congress has already narrowed the potential scope of federal jurisdiction under the Federal Power Act by limiting it to sales for resale of "electric energy in interstate commerce" and crafting a definition that is considerably more narrow than the definition applied by the courts. See 16 U.S.C. §824(c) (limiting the definition to only such electricity that is transmitted from one state and consumed in another).

Although S.1149 enables the states to refuse to allow certain utilities to recover rates that have previously been authorized by FERC, it is by definition within Congress' province to enact legislation regulating interstate commerce without violating the Commerce Clause.

What drawbacks exist in the bill? From one viewpoint it may be argued that the bill goes too far, that it is not necessary to endow the states with additional authority in order to correct a misinterpretation of the Act by FERC in the Grand Gulf decision. It might instead be sufficient to restate, with emphasis, Congress' original entrustment of jurisdiction over generating facilities to the states exclusively. After all, the heart of the problem exemplified in the Grand Gulf decision lies not in the literal words of the Act itself but in FERC's interpretation of them, an interpretation that is as bold as it is unprecedented. It is the administrative expansion of the Act's jurisdictional boundaries rather than the Act itself, that most needs correction.

On the other hand, the primary concern we have is that S.1149 may not go far enough. The problem encompassed by the Grand Gulf litigation is that FERC has repudiated agreements reached among the operating subsidiaries of MSU and reallocated the costs of the Grand Gulf plant in proportions that no astute observer could have ever foreseen. S.1149 treats one of the outgrowths of the problem -- the need to modify sudden price increases at the retail level -- but it does not directly confront the more odious aspect of the Agency's policy -- FERC's insistence on abrogating agreements reached by members of a pool and its predilection toward system-wide costing or cost equalization. FERC has suggested, at least implicitly, that its ruling in the Grand Gulf case is necessary to preserve the MSU pool. None of the companies I have represented is opposed to the concept of power pooling per se, but the danger posed in FERC's approach is not only that it visits massive, unanticipated energy costs upon various states but that it undermines the forces that support the power pooling concept itself. If Congress intends to promote power pooling, as it clearly did when the Act was passed, it must guard against administrative excesses that create powerful disincentives for joining a pool. In the wake of the Grand Gulf ruling, any prudent utility that considers joining a power pool would have to factor into its calculus the prospect of being involuntarily saddled with shares of generation plant costs incurred by other pool members. Would a reasonable utility consider joining a pool if it knew it could be forced later, contrary to its contractual commitments, to pay 36% of a $3.6 billion plant that generates power the utility will never need? Would a reasonable regulatory commission permit a utility under its jurisdiction to run such a risk if it were so inclined?

This question underscores the fundamental problem posed in FERC's Grand Gulf decision that S.1149 can only tangentially address. As proposed, S.1149 gives the states an explicit tool to correct problems that FERC's decisions have created. Obviously, however, the more beneficial long-term solution would be to avert the problems at their source. Ultimately, a strong signal needs to be sent from Congress to FERC and to the public utility holding companies that FERC lacks the authority to impose system-wide cost equalization or its variants (such as "nuclear cost equalization" -- the explicit objective of FERC's Grand Gulf decision) upon members of an otherwise voluntary power pool. If FERC possesses such authority over power pools, the threat posed to effective state regulation over generating costs is untenable, with FERC essentially usurping the province of the state commissions.

One other related concern arises with respect to S.1149, as currently drafted. That is, if a utility does seek and obtain pre-construction approval, would the state thereafter be powerless to challenge the prudence of the utility in continuing an investment that becomes unwise, or, in increasing its share of the project? If, for example, a utility convinces a state commission to approve a plant based on load growth projections that are not well-founded, would S.1149, under the doctrine of expressio unius est exclusio alterius foreclose all subsequent inquiry or cost disallowance by the state commission? We believe that the public interest is best served when two levels of inquiry -- state and federal -- are permitted to co-exist and to protect ratepayers against imprudent construction costs.

Although S.1149 does not completely remedy the problems outlined above, it offers a potent means of circumscribing the excesses that the Grand Gulf case so aptly signifies. Industrial customers need to be able to rely on long range forecasts of energy costs in order to make informed choices about their own business operations. FERC's decision makes any such reliance misguided and naive. To the extent that S.1149 would allow state commissioners to mitigate the dislocations created in the wake of the Grand Gulf decision, we welcome it and urge its passage.

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